

BUILDING WEALTH

*A Layman's Guide
to Trust Planning*

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Chapter 1

FIVE REAL-LIFE CASES

In the simplest of all possible worlds, you own a stamp collection that could someday have value. You want to make certain that after your death it ends up in the hands of your granddaughter Celia. For at least three of her ten years, the youngster has shown deep interest in stamp collecting. Your son and daughter-in-law have a brood of six children. The parents feel that a stamp collection could become a toy for the younger children. They propose that you hold on to your stamps until Celia is older. For various reasons you do not want to wait. You hand the stamp collection over to a trusted friend and ask him to keep it safely until the granddaughter has come of age. You leave for that long-planned trip through Europe.

The relationship existing between you, your friend, and your granddaughter parallels that which might be established under a trust arrangement. You are the grantor, trustor, donor, or settlor of the trust. Your friend who has the task of keeping the stamp collection serves as the trustee. Your granddaughter is the beneficiary of the informal trust.

The agreement under which the trustee, your friend, acts in your behalf stands as the paradigm of the formal trust agreement. The modern trust agreement is formalized in a document that closely resembles your word-of-mouth arrangement. The principle is clear: A person owning property may transfer that property to another person, the trustee, who takes care of the property for the benefit of a third person. If the property were to produce income, the trustee could distribute that income, either to the person who

created the trust or to others designated by the trustor. The recipients of the income would be called beneficiaries. The person who would eventually assume ownership of the property would also qualify as a beneficiary.

Note how trusts worked in five real-life situations.

A CASE OF PHYSICAL DECLINE

James Rentner, 87, had always been sound of mind and body. He had buried his wife of more than 50 years when he himself had barely reached the age of 82. He lived in the suburban home that he had bought for \$6,800 in 1940 with the aid of a Federal Housing Administration mortgage loan. He knew his property had increased in value, but he had no idea by how much.

When James "took a fall," in the parlance of his family, the shock unsettled him. In falling he had injured his pride more than his body, but his left arm and side were severely bruised. When a month later he fell again for no apparent reason, he began to understand the limitations that age was imposing on him.

James spoke to his oldest son. James's four children, already concerned, had agreed that their father should give up what they saw as the ancestral home and move in with the older of his two daughters. The oldest son, James Jr., passed that message along to his father.

Eventually James Sr. agreed. He had no estate to speak of aside from the house; he had worked all his life as a carpenter, and though his home was in excellent repair, he had saved little. He had in fact spent thousands of dollars over the years on materials that he used in do-it-yourself projects around the house. The prospect of leaving the home that he had occupied for nearly 40 years repelled and frightened him. But he had to face the facts: He could no longer live alone and risk an injury that might render him unable even to call for help.

But James wanted to retain a measure of independence. That meant he wanted to have the proceeds from the sale of the house (1) kept available for his use as required; and (2) supervised and invested by someone who understood securities and income taxes and was skilled with figures. He himself had no time for or interest in such matters.

James Jr. qualified on all counts. Since the father hoped also that any estate remaining after his death could be divided equally among his children, a trust agreement was prepared by a lawyer who was a friend of the family. Under the trust, James Jr. became the trustee. Father James could obtain funds as he needed them simply by asking his son. The cost of his upkeep at his daughter's house would be paid regularly out of the trust fund. The proceeds of the sale of James's house came to \$43,000 after all obligations had been paid off.

The trustee and the law took care of the rest. James Sr. lived comfortably for three more years, finally succumbing after a bout of pneumonia. At the time of his death, only \$12,000 remained in the trust fund. Within three months, part of that sum was spent to pay funeral, hospital, and other costs, and the remainder, divided into four equal segments, was distributed by James Jr., trustee, to his two sisters, one brother, and himself.

James Sr. had established a living trust. While he lived, it had been administered by his oldest son, and in that process, with the trust fund invested carefully in high-yield securities, it had earned income that James Rentner, Sr., could use for his own benefit.

On his father's death, James Jr. had the task of closing out his father's estate. But that proved relatively uncomplicated, partly because the trust agreement made probate unnecessary. The trust agreement ceased to have legal meaning or force once the final distribution of trust assets had been made.

ESTATE MANAGEMENT

Five members of the Jepson family decided in 1911 to form a small real estate corporation. The group planned to develop residential property by building single-family homes. The corporation purchased a 60-acre tract with 1,900 feet of frontage on a state highway.

For more than two decades, the property remained undeveloped. Then two of the shareholders decided with the consent of the entire group that the original plan should be abandoned. Instead, the land was to be held indefinitely. The two, John and Michael Jepson, were convinced that the property would increase in value because of its location along the highway.

Very appropriately, John and Michael thought they needed expert, continuing help. Basically they had two ways to go in order to transfer management responsibilities to other shoulders: They could set up a trust involving a corporate trustee—or an individual trustee if they took care to ensure successor-trustees in the event of the first incumbent's death—or they could arrange a contractual investment. They might have found other alternatives, but they decided on the trust arrangement.

Two trustees, an accountant and a lawyer, were eventually retained. Provision was made for succession in the event of the death of either. Under this management system, parcels of the tract were leased, and an income flow began to build up.

During the early years of ownership, when the Jepsens themselves had retained control of the tract of land, family disagreements had kept the land unimproved. Nothing was lost because the land continued to increase in value, but once the trustees began work, with *carte blanche* to encourage growth and development, the value of the property rose dramatically.

Over the years, the trustees received a number of offers to buy portions of the land. The trustees, of course, declined the offers because they had no authority to sell. In one instance, a potential buyer offered \$25,000 for a parcel that 20 years later was leased at an annual rental of \$48,400 on a net basis.

After nearly 30 years of management, the original tract had 19 tenants. All but six had improved their portions, and those six occupied parcels that the trustees themselves, with approval of the original shareholders, had improved. The 13 other tenants had long-term leases under whose terms the improvements reverted to the trust on expiration. The leasehold agreements also had rent escalation clauses that tied the rents to the consumer price index. Thus, rent adjustments could be made periodically. By the middle 1970s, the tract was producing a net income of \$300,000.

The management responsibilities devolved entirely on the two trustees. Their continuous, concentrated planning and administrative work was the factor that made the property grow and function as an enterprise. For many years, they made all the key decisions regarding the tract. But the trustees did more. They discharged such day-to-day functions as ordering accounts, collecting rents, renegotiating leases, and conducting other

stewardship activities. In later years, the proceeds were paid out regularly to the heirs, some of whom hardly knew where the property was located.

The trust arrangement turned out to be an extremely advantageous way of administering the original Jepson Corporation. As the need arose, the trustees even provided advice and counsel to interested members of the family.

When one of the trustees, the lawyer, died, he was replaced quickly. The accountant's familiarity with the affairs of the trust helped to ensure continuity during the transition period. By the end of that period, a new lawyer-trustee had been named, and the trust could very well go on producing substantial income for years.

THE SPECIAL GOAL

Henry and Joanne Brown believed deeply that a college education would be important for their son Curt, aged eight. They knew they could not halt the steady rise in college tuition and other costs, but they decided to develop a long-range strategy, some ten years in advance of Curt's entry into college, that would at least help defray some of the expenses. A short-term trust provided the answer.

Henry and Joanne contacted their lawyer, who filled out a two-page agreement under which some of the family's interest-bearing assets went into trust for Curt. Henry became the trustee. Thus, he could make all the investment decisions relating to the fund.

The mechanics were relatively simple. Henry and Joanne placed \$15,000 worth of 8 percent bonds in trust for at least ten years. Under this "ten-years-and-a-day," or short-term, trust, Curt received the interest from a custodial account each year: \$1,200. If the couple had not set up the trust and had given the interest to Curt outright, he would have received only \$600 after taxes, since the Browns were in the 50 percent tax bracket. Even if they had been in the 28 percent bracket, young Curt would have netted only \$864 without a trust.

In ten years, the interest from \$15,000 invested in 8 percent bonds amounted to \$12,000. Henry and Joanne put each year's income from the bonds into a custodial savings account at $5\frac{1}{4}$

percent interest, compounded monthly. Thus, after ten years, the college fund accumulated more than \$15,300 from the bond and savings account interest—in addition to the original \$15,000. Had the couple invested the trust income in time deposits, the college fund would have grown to \$16,977 over a decade, assuming that the time deposits would yield 7½ percent.

At the end of each year, Henry had to file a tax return Form 1041 for the trust, but his income taxes were lower because the trust income went into an account for Curt each year. Beyond that, the portion of the parents' estate that had been placed in trust would not be taxable as part of their estate in the event they died during the life of the trust. In addition, by putting the yearly trust income into a custodial account with Joanne and not Henry as the custodian, Henry made certain that the account also would stay out of his estate in case he died during the life of the trust.

Some subtle problems may arise where a short-term trust is established. For example, parents may want to use payments from the trust to discharge part of their legal obligations to support their child. But if they do, income taxes may be due. In some states, support for an upper-class child might be viewed as including college, but the legal support responsibility ends at age 18 in many states.

Henry and Joanne checked out these problems—and avoided them. They also learned that their leeway in altering and investing the trust fund was limited, because Henry's responsibility as trustee required that he make investment or portfolio moves in Curt's interest, not in his own or Joanne's.

Henry and Joanne had also investigated alternatives to establishing a trust. They found that they could have built a bigger college fund with the same assets if they had put the bonds directly into a custodial account. That would have involved less repetitive paperwork than the trust, but the couple would have had to pay a gift tax, and they would not have been entitled to recover the original \$15,000 for their own use later.

THE CHARITABLE TRUST

Hobart Crandon was a widower. He had a 38-year-old daughter, Monica. Out of the moderate wealth that he had accumulated in

the construction business, Crandon wanted to provide for his college alma mater and for Monica during her lifetime. He combined the two goals by establishing a unitrust.

Under the unitrust, a form of charitable trust agreement, distributions may be made to a living beneficiary for his or her lifetime. Afterward, the principal goes to the designated beneficiary—in Crandon's case, the college he had attended. The distributions fluctuate; they are figured as a fixed percentage of the annually determined value of all the trust assets.

Crandon's motivations in both instances were extremely praiseworthy. The school he had attended, like most colleges, needed funds for a myriad of things, but it could wait for them. On the other hand, Monica, partially paralyzed from injuries incurred in an auto accident at the age of 16, needed immediate support and would continue to need it if Crandon predeceased her. Monica lived alone. Her prospects of marrying were almost nil, and she could not work. Her father had for years been paying all her bills.

After discussing the problem with his financial advisor, Crandon assigned \$100,000 in ABC stock to the trust. He had purchased the stock for \$10 per share; its value had increased to \$30 a share, but the stock paid no dividends. Crandon specified that the stock should be sold. The proceeds were reinvested to provide Monica with the needed annual income.

Crandon could have made an outright gift of stock to Monica under a trust agreement, but the gift thus formalized would have cost an additional \$30,000 in taxes. The following table shows what would have occurred if Crandon had made an outright gift and what did occur when he set up the unitrust.

Two questions arose as Crandon was finalizing his plans for the unitrust. Since the unitrust provides no flexibility regarding distributions, and since the trust principal cannot be invaded, what happens if Monica encounters special or extraordinary expenses? Secondly, was it actually Crandon's intention to have the entire corpus, or principal, of the trust pass to Crandon's alma mater on Monica's death?

Crandon handled the first question simply. He established a "sprinkling" trust to take care of Monica's special expenses and the normal needs of a son and some grandchildren. The trustee was

	<i>Outright Gift</i>	<i>Gift in Unitrust</i>
Tax payable by trust for Monica on capital gain realized on sale of ABC stock	\$15,300	\$ 0
Gift tax on transfer	10,000 ^a	4,800 ^a
Reduction in income tax from charitable contribution deduction	<u>0</u>	<u>(9,500)</u>
Total tax cost	<u>\$25,300</u>	<u>\$ (4,700)</u>
Difference in total tax cost		<u>30,000</u>
Total		<u>\$25,300</u>

^aIf an outright gift had been made, the gift tax would have been computed on the basis of \$115,300 as the value of the securities transferred to the trust for Monica. Under the unitrust, only \$100,000 in securities were transferred. Of that total, \$13,000 represented the value of the remainder interest, leaving an \$87,000 gift to Monica; a gift tax was levied on the \$13,000.

thus empowered to distribute funds to the beneficiaries on the basis of need without having to equalize distributions.

Regarding the second question, Crandon did want the entire trust principal to go to his college. He felt strongly that giving to the institution in this manner, at the end of an unspecified period of time, would satisfy his basic goals. He admitted that the prospect of saving \$30,000 on a \$100,000 transfer while giving aid to a worthwhile charity provided powerful motivation.

In the event, Monica was well taken care of for over 20 full years. Crandon died before the expiration of that period and thus did not live to see his bequest for the college finally transferred, but the college had been brought into his plans and knew of the arrangement.

The body of the trust fund grew substantially before Monica's death. As a result of wise investment and management of the fund, after 20 years the principal had grown to \$269,000. Obviously, such results cannot be guaranteed; the trustee had simply invested wisely. The stock market remains unpredictable to a degree that cannot surprise anyone familiar with it, but the possibility of such gains exists.

THE WIDOW'S TRUST

Allen Doane decided in the mid-1970s to set up a widow's, or sequential, trust, to dispose of his estate after death. He wanted

primarily to ensure support and financial protection for his wife, Sally. But he also sought to ensure that the remainder of his \$400,000 estate would go to his son, Peter, once his widow had been taken care of. Naturally, he wanted to accomplish these goals while minimizing the estate's losses through taxation.

When Allen finally succumbed to the illnesses that had plagued him for years, the terms of the widow's trust took over. Allen's estate divided neatly into A (widow's) and B (residuary) trust segments of \$200,000 each after taxes and expenses. (In most actual cases, of course, such neat divisions are seldom possible.) Allen's widow could receive income from trusts A and B during her lifetime. She could also draw portions of the Trust A principal as needed for her care, maintenance, and support. Once the Trust A principal had been exhausted, she could draw against the Trust B principal.

On Sally's death, the sum remaining in Trust A would go either to the heirs designated in the original trust instrument—son Peter and his family, if any—or to another beneficiary designated by Sally in her lifetime. The nonmarital portion, or Trust B, would pass in a continuing trust arrangement or outright to Peter and his family, as specified in the trust agreement. Because this nonmarital portion passes on to beneficiaries designated by Sally's husband and not by her, it is not subject to her unlimited use and is not considered part of her taxable estate.

For the record, Allen died on January 1, 1977. Peter's taxable income was nonexistent in 1977, but it rose to \$7,650 in 1978, 1979, and 1980, and \$9,000 in 1981. Sally died on January 1, 1982. Exhibit 1 shows the Trust B taxable net income, federal taxes paid, and net

Exhibit 1. Trust B ledger on original \$200,000.

<i>Year</i>	<i>Taxable Net Income</i>	<i>Trust B Federal Taxes</i>	<i>Net Annual Accumulation</i>
1977	\$10,000.00	\$ 2,190.00	\$ 7,810.00
1978	10,394.41	2,316.21	8,078.20
1979	10,802.36	2,444.76	8,357.60
1980	11,224.41	2,581.81	8,642.60
1981	11,660.87	2,721.48	8,939.39
Totals	\$54,082.05	\$12,254.26	\$41,827.79

Note: Assumes only U.S. interest earned at 5.5 percent, no capital gains.

annual accumulation for the five years following Allen's death and preceding Sally's.

Now the real effects of the trust arrangement can be seen. The entire Trust B remainder was distributed to Peter in 1982. On Form 4970 he would, barring further changes in the tax laws, owe a partial tax for 1982 of \$1,521 on receipt of the \$241,827.79. Sally would owe no federal taxes at death on that sum, because it was held in a nonmarital trust.

Sally would also owe no federal tax on Trust A if with the consent of the trustee she had invaded the principal for \$6,000–\$10,000 or more annually for the last five years of her life. Those deductions would have reduced Trust A to a total value less than the \$175,625 that can pass tax free under federal estate tax laws.

Note also how the trust arrangement saved the widow money that would have been paid out in taxes after her husband's death. Drawing \$20,000 annually from both principal and interest on the Trust A portion of the estate, she paid \$765 in federal taxes in 1977. Without the trust arrangement, an income of \$20,000 from her husband's estate would have cost her \$2,911 in taxes in 1977.

In five years Sally and her son saved more than \$9,000 overall through use of the widow's trust. In concrete terms, the widow saved \$2,146 in 1977 and \$2,882 in 1978. Subsequent tax savings brought the five-year average to about \$3,000. Adding to that \$15,000 the \$7,800 saved in federal estate taxes, and subtracting the \$1,521 paid by the son as well as the \$12,254 federal income taxes paid under Trust B, the \$9,000 figure is reached.

The trust would have saved even more tax money if Peter had had one or more siblings. The distribution at the end would have been spread over two or more taxpaying children.

POSTSCRIPT

These five cases illustrate some of the ways in which trusts may be created to accomplish specific goals. The trustors in the five cases covered a relatively broad range of economic situations, and they had widely divergent purposes in establishing their trusts.

Because the trust agreement typically contains a wealth of detailed instructions, it should be prepared by an attorney. This was done in each of the five cases, and the result in each case was a

clear specification of the understanding between the trustor and the trustee.

Where and how did the trust originate? Chapter 2 discusses, in brief, the historical background of the modern trust.

Chapter 2

HISTORICAL BACKGROUND

The first genuine trusts appeared centuries ago in England. Crusaders preparing to go off to war are said to have turned their property over to trusted others for administration. The income from such property was to be used to pay the owners' obligations and to care for their families.

The simple early trust was also used to disguise the ownership of property. Under the terms of a private agreement, one man would transfer property to another. The benefits or income from the property would continue to flow to the person who created the trust. The trustee, or the person to whom the property had been conveyed, would hold legal or actual ownership. Thus, the original owner's interest would remain hidden.

The concepts underlying the trust had been born much earlier. Those concepts had roots going back to Ancient Rome and to the customs of old Germanic tribes.

THE ROMAN CONCEPTS

Many modern legal systems have their origins at least partly in Roman law. Thus, directly or indirectly, many constructs and concepts familiar to us today derive from Roman usage.

In a sense, the modern trust has evolved from Roman views on property as a distinct entity. The Romans did not use trusts as such—and they had no parallel for the modern practice under which a trustee can independently administer and control property for the benefit of another—but the Romans developed fiduciary systems that accomplished similar purposes in different ways.

The Roman legal concept that most closely approximated the trust was the *fiducia*, a device for conferring on one person primary obligations for the property of another person. The *fiducia* constituted a two-step transaction. In the first, the ownership of property was conveyed to a *fiduciary*. In the second step, the fiduciary agreed to carry out the purpose for which the transfer had been made.

The *fideicommissum*, as the transaction came to be called, underwent extensive elaboration over the centuries. It had been devised as a means of circumventing the rule that only Roman citizens could be heirs. Later, it came into wide use as a method of disposing of property after death.

At least four basic factors distinguish the *fideicommissum* from today's trust:

1. In a trust, the fiduciary's legal ownership and the beneficiary's equitable ownership run concurrently. In the *fideicommissum*, the ownership of the property went over to the *fideicommissary* (beneficiary) when the fiduciary's ownership ended, or, conversely, the fiduciary's ownership ended when the property was conveyed to the *fideicommissary*.
2. In consequence, the *fideicommissum* did not distinguish between a legal and an equitable estate. The trust, of course, does.
3. Once vested, the *fideicommissary's* rights were inalienable. They could not be destroyed or burdened, which is not always the case where trusts are concerned.
4. The *fideicommissum* almost always came about as a result of a testamentary act. The trust created during life—the living or inter vivos trust, a common modern form—appears to have arisen only in some Roman-related legal systems, for example, that of the Netherlands. In northwestern Europe a trend toward inter vivos settlements of property dispositions became observable later as aspects of marriage settlements.

GERMANIC LAW

A closer correlate to the modern trust appears in old Germanic law. The will did not exist as a device for disposing of property after death. By established custom, however, property could be

conveyed to a *Salmann*, a person who undertook to dispose of the property in accordance with the donor's instructions. The donor usually reserved a life interest in the property. The *Salmann* became the legal owner of the property, but he had the fiduciary obligation to obey the donor's wishes.

Modern authorities have found clear precedents for the trust in the institution of the *Salmann*. For example, the roles of the executor and administrator in English law were undoubtedly foreshadowed by the *Salmann* and his functions.

WESTERN EUROPEAN CONCEPTS

The influence of Roman law dwindled in western Europe for many centuries, but a revival of that influence was noted in nineteenth-century Germany. Since the role of the executor under a will was limited, the *Treuhänd* was developed as a concept and an institution. Roman precedents have been held to be functional in the new development, but the *Treuhänd* had no inevitable connection to the law of succession.

In a *Treuhänd*, property was transferred to the ownership of a *Treuhänder* for a specific purpose. The *Treuhänder* who sought to violate that purpose would find himself unable to transfer property, and the settlor would have a case against the *Treuhänder* for any loss.

The beneficiary under a *Treuhänd* apparently had only the right to take action to compel the *Treuhänder* to carry out the terms of the basic agreement that were in the beneficiary's favor. By contrast with the trust beneficiary, the *Treuhänd* nominee had the right to take legal action against the trust itself. Thus, some authorities have held that failure to perform under the *Treuhänd* agreement gave the settlor only the right to recover the property.

The French *hypothec* concept has also been compared to that of the trust. In the *hypothec*, one person takes charge of the property of another. *Hypothechs* were long used for such purposes as provision of security for a debt, but they have also been used in fiduciary or quasi-fiduciary situations to safeguard a person's rights in property. For example, under French civil law a married woman might hold a *hypothec* over property owned by her husband. The

purpose would be to protect the wife's marital right of property. A ward might have a similar claim on the property of a guardian.

ENGLISH AND AMERICAN ORIGINS

The trust as we know it today in the United States can trace its roots directly to practices established in English common law.

The modern trust grew out of the medieval "use." In England in the Middle Ages, the owner of land might transfer his title in the land to another, who would then hold it "to the use of" the transferor or of some other person or institution. Initially, the use was not recognized at law; thus, a use agreement was for a long period unenforceable. The use transferee, the forerunner of today's trustee, had nothing more than a moral obligation to carry out the wishes of the transferor.

The use had both licit and illicit purposes. On the legitimate side, it provided a means of administering or managing property and of selling or otherwise disposing of it. On the illegal side, the use served as a means of defrauding creditors and cheating feudal landlords of their dues. In other cases, it served to make it possible for religious institutions to derive benefits from land that they could not legally own.

The Statutes of Mortmain prohibited church ownership of land. The common-law courts refused to uphold uses that gave ecclesiastical institutions any kind of ownership. But in the fourteenth century, the Chancery began to respond to church appeals and eventually directed that the use be honored as a transfer of property. At the same time, the church was granted the right to collect the income from the property and to enjoy other fruits of ownership. The use had become a legal means of conveying property for the use of the person or institution named by the transferor.

The Statute of Uses, passed by the English Parliament in 1535, was designed to abolish the use. The statute is said to have "executed the use"—it automatically transferred title in the subject property to the beneficiary. The statute had an obvious purpose: to end the practices under which feudal lords, and in particular the king as the supreme overlord, lost substantial revenues.

Over the next two centuries, however, the use not only sur-

vived, it escaped the operation of the statute as a result of legal interpretations and decisions, and eventually it became recognizable as the trust. Partly because of the statute, a greater variety of legal estates were allowed. Numerous changes were made in methods of transferring land. In 1540, the Statute of Wills legalized for the first time the disposition of land by will.

By the mid-1700s, England's courts of equity had established by successive decisions all the characteristics of the modern trust. After the American Revolution, the English precedents in this area were accepted in the United States along with the great bulk of other common-law concepts and decisions. The English equity system became part of the common law in the United States.

TRUST EVOLUTION

In evolving into what we know as the modern trust, the use had, over time, acquired a character of its own. It came to play a part in the life of the English, and then the American, people. Among its other social applications, it enabled persons choosing a losing side in England's civil wars to avoid forfeiture of land on charges of treason. In a time when married women were unable to own property, the use made it possible for a father to place property in trust for a married daughter.

By degrees, the new institution of the trust came to have fundamentally distinguishing characteristics. Where the medieval use was developed with respect to land, the trust became applicable to all forms of property and eventually to all forms of commercial securities.

Whereas the medieval use was *passive*, the trust became active. Under the use, the *feoffee*—the person to whom the title was transferred—was expected to allow the beneficiary to take action in relation to the land. The trust later, in the vast majority of cases, gave the trustee the right and power to administer the property. Today, enforceable duties must be assigned to the trustee, or the trust is "executed" and legal title to the property is vested in the beneficial owner.

The courts have established a body of equitable rules controlling and defining the administrative powers of the trustee. These rules relate to a relatively broad range of trustee responsibilities—for the

most part, with a focus on trustee investments. Thus, today you can find protocols on trustees' powers to sell, lease, or mortgage trust property; to maintain and advance the interests of beneficiaries; and to appoint agents. Rules relating to many other aspects of trusts might be cited.

Over the past century and more, many of these rules have been incorporated into the legal systems of the United States and the British Commonwealth countries. An example is the "prudent-man" rule governing investments of trust funds by a trustee. The rule dates back to the *Harvard College v. Amory* decision of the Supreme Judicial Court of Massachusetts in 1830.¹ But until 1937, the rule had force in only six states, in each case by judicial decision, not legislative enactment. The prudent-man rule has today been incorporated into the laws of 41 states. In the other nine states (Alabama, Alaska, Arizona, Georgia, Indiana, Iowa, Montana, Nebraska, and Wyoming) those investments that are appropriate and legal for trust funds are listed for the information of trustees. The District of Columbia also does not require observance of the prudent-man rule.

In its prototypical form, the prudent-man rule had a basic and fairly uniform phraseology. A model published in 1951 read:

In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing property for the benefit of another a fiduciary shall exercise the judgment and care, under the circumstances then prevailing, which men of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.²

CHARITABLE GIFTS AND CIVIL LAW

The civil-law systems of foreign countries treat gifts for charitable purposes differently than Anglo-American common law treats them. For the most part, the donor faces more rigorous requirements in a civil-law system than in the United States or England.

¹*Harvard College v. Amory*, 9 Pick. 446 (Mass., 1830).

²*The American Fiduciary's Investment Problem* (Boston: Vance, Sanders & Co., 1951), p. 9.

Three choices are generally open to people seeking to make charitable gifts under Anglo-American law. First, they can donate directly to the institution or foundation. In such a case, they rely on the institution's own regulations to ensure that their wishes are fulfilled. Second, donors can transfer the property to a trustee or trustees and have it reconveyed to the institution. Third, donors may be forced to establish a new trust, one specifically formed to carry out their instructions.

By contrast, under civil law donors may have only the first of these options. They may have to transfer property to an existing institution that will then be obligated to fulfill the donors' instructions. This derives directly from classical Roman law, under which would-be donors had only this single avenue available for giving charitable gifts.

Traces of Roman influence have also been detected in alternative methods of making charitable gifts. For example, in Germany the *Treuhänd* concept was extended, and the church itself became the *Treuhänder*. The right to create a new foundation to carry out specific charitable purposes was fairly widely upheld. In modern German law, the *Stiftung*, or foundation, has acquired a corporate personality and must have a board of directors (*Vorstand*).

RECOGNITION OF ALTERNATIVE USES

In the nineteenth and twentieth centuries, the trust has acquired new meanings and found new applications. Some changes have already been noted: For example, the trust came to be applicable to all forms of property, including commercial securities.

In at least three areas—provisions for the family, social applications, and commercial functions—the trust that developed out of the medieval use became progressively recognized as an important legal device.

PROVISIONS FOR THE FAMILY

Among its main effects, the trust has created the legal machinery through which the settlor, or trustor, can provide for the successive members of his family. Such provision cannot be projected indefinitely into the future, because, with the general exception of the charitable trust, no trust can run in perpetuity. But the law

permits broad diversity. The importance of the right to provide for family members is underscored by the fact that a trust established for such a purpose may come into being either during the trustor's life or after his or her death.

The marriage settlement offers an example of a trust format that may be executed by a living donor. The settlement may take effect on the marriage of either the trustor or a member of the immediate family. Under such a settlement, property is usually assigned to trustees for the benefit of the husband and wife while they are both living. Thereafter, the trust is generally administered for the benefit of the survivor for the duration of his or her life. Finally, the estate is typically divided among the couple's children or grandchildren on attainment of a specific age.

Trusts established under wills—testamentary trusts—very often provide for the sale of specified assets or of all the testator's assets. The proceeds of the sale will then be invested in income-bearing securities for the benefit of specified beneficiaries, usually the surviving spouse as well as the children.

Because a family trust is specifically designed to provide financial security for a person's close relatives, some legal devices have been developed for the protection of those relatives. Some states require the use of such devices whether or not the trustor incorporates them into the trust document. For example, an infant beneficiary may be prohibited from owning an estate interest because of lack of capacity. In effect, the child is not old enough to transact business in his own name; in time, of course, the interest will, other things being equal, be transferred to the beneficiary. In the meantime, the trustees will usually have discretionary powers over the infant's interest. They may use the income for the infant's maintenance, education, and benefit, whether or not the parents are alive and able to provide support.

Persons of unsound mind or irresponsible habits receive special consideration under all modern legal systems, as do handicapped persons. Most legal systems also make it possible for all such persons to be protected by trusts. Trustees will usually be empowered to utilize income and, if necessary, capital for the maintenance and benefit of persons of unsound mind. For those beneficiaries who have shown themselves to be irresponsible, the "spendthrift trust," or spendthrift clause in a trust document,

generally specifies that the beneficiary may not intentionally or unintentionally encumber any trust created for his benefit. A high-spirited beneficiary cannot gratuitously hold the trust responsible, for example, for the price of a new red Rolls-Royce.

SOCIAL APPLICATIONS

Trusts have achieved currency for a variety of social and public purposes. Labor unions, pension plans, social clubs, and philanthropic organizations commonly hold their property in trust. The trustees typically represent the organization to the outside world.

Charitable trusts rank among the most important of those used for social purposes. Specific beneficiaries need not be mentioned in the trust instrument; the public, or society as a whole, may be regarded as the beneficiary of such a trust. By general consensus, the benefits of this type of trust flow through individuals to the state or to society as a whole.

The definition of a charity has proved elusive. A charity in British and American usage usually refers to an educational, religious, or community welfare organization. But because the words *philanthropic* and *benevolent* have been interpreted as having broader meanings than *charitable*, trusts established for such purposes have in some cases been declared unsupportable at law.

Many trusts ostensibly created for charitable purposes have proved abortive for diverse reasons—for example, because the trust did not benefit the public generally or the trust benefits were divided between charitable and clearly noncharitable objects or beneficiaries. Such trusts have been forced to conform to the general laws governing private trusts.

COMMERCIAL FUNCTIONS

Trusts have been used increasingly in the commercial life of the twentieth century. Trust companies for business organizations, for example, have commonly acted as trustees for their clients' bond issues. In these cases, the trust company performs a variety of services. After taking title to or a lien on any property offered as security, the trust company certifies the genuineness of each bond, ensures that the client corporation fulfills the obligations specified in the bond indenture, and takes any necessary legal action to

protect the bondholder if the corporation defaults on its obligations.

The trust company assumes other functions, too. Typically, it will manage the sinking fund established to underwrite redemption of the bonds and will also make interest and principal payments to bondholders in behalf of the corporation. In a special situation, trust companies may act as trustees for equipment-bond certificates issued to enable railroads to buy locomotives and rolling stock.

These basic services have been supplemented by more contemporary applications. In recent times, trust companies have come to act as trustees for employee pension and profit-sharing plans. These activities have attracted widespread attention as the plans themselves have come under legislative and court scrutiny. Trust company responsibilities may vary in such cases, but depending on the terms of the plans, the trust company will probably invest the funds in securities or life insurance annuities.

Other complex developments of the commercial trust might be noted. For example, a trust company may be called on to act as trustee of a business insurance trust, a device widely used to minimize tax losses. The trust company ensures the conveyance of a business enterprise, or of a major interest in it, to one or more beneficiaries. The latter may be a relative or associate of the trustor.

OTHER MODERN DEVELOPMENTS

Historically, the trust is an outgrowth of processes or areas *not* covered by the Statute of Uses of 1535. In today's context, personal trusts—the subject of this book—have become immensely complex. The trust as a legal device has developed into one of the most comprehensive institutions of modern law.

Internationally, the trust has been more and more widely accepted as a means of vesting ownership of property in one person for the benefit of another person or persons. Although it was created under common law, the trust has been accepted for general use in many civil-law countries. It has been introduced into the civil-law systems of Liechtenstein, Mexico, Panama, Puerto Rico, and Venezuela and given legal status in such countries as Sri Lanka

(formerly Ceylon) and South Africa, both of which have essentially Roman-Dutch systems of law. In the United States, the trust has become an acceptable tool for passing title to property and providing for beneficiaries in the civil-law state of Louisiana.

Modern tax law affects trusts and their creation so intimately that a trust instrument can hardly be contemplated without attention to the tax consequences of the several trust clauses. In fact, many of the trust cases heard today in U.S. courts have to do with taxes and taxation. Other cases deal with charitable gifts, specific forms of trusts, or the duties of trustees. Issues relating to the duties of trustees have become particularly important and sensitive under the Employee Retirement Income Security Act of 1974.

As will be noted later, both the Tax Reform Act of 1976 and the Revenue Act of 1978 affected existing trusts as well as those yet to be created. For example, accumulation trusts established before passage of these laws have been extensively reviewed for the purpose of ascertaining what effects, if any, the laws would have on the trust holdings. In many cases, trust instruments have had to be rewritten.

Probate and the role of trusts in helping property owners to avoid probate have become the subjects of general debate. The argument has spilled over into everyday life. Avoiding probate has, rightly or wrongly, become the goal of many persons who decide to establish trusts.

The contention that probate should be avoided at any cost has some merit, but in general, this is not a good argument. And trusts have gained popularity for many other reasons. Notably, more and more citizens of moderate means have come to recognize that a trust may offer them, as well as the very rich, a means of safeguarding their families, avoiding unnecessary taxes, or accomplishing some other valid purpose.

Such developments suggest that the trust, with its long history in English common law, has arrived and will become continually more utilitarian. In the affluent society of the United States in particular, trusts will undoubtedly continue to proliferate. Thus, the need to understand the trust as it presently exists and functions has become pressing.

Chapter 3

THE TRUST TODAY

A DEFINITION

In the baldest terms, a trust is a right of property legally held by one person for the benefit of another. Almost unlimited variations of that simplistic definition may be found. To cite only five:

A "trust" is an estate, legal title to which is vested in a trustee, while equitable title is held by individuals who bear no contractual relations among themselves.¹

A "trust" is an equitable right, title, or interest in property, real or personal, distinct from the legal ownership thereof.²

A "trust" is an obligation arising out of a confidence reposed in a person, for another's benefit, to apply property faithfully and according to such confidence.³

A "trust" is one of several juridical devices whereby one person is enabled to deal with property for benefit of another person, and among such devices are bailment, guardianship, and agency.⁴

A client's delivery of funds to her attorney for investment created "trust," and attorney, by taking money and promising to invest it safely and return it with interests within three to five years, assumed duties of "trustee" toward client.⁵

WHAT A TRUST IS NOT

All such definitions stress what a trust is; what it is not may also help to clarify the term.

A trust is *not* an agency arrangement, a bailment, or an executorship, even though it resembles all three. The trust and the agency differ essentially. In the former, title and control of property pass according to the terms of the trust agreement to a trustee who acts

¹Krensky v. De Swarte, 82 N.E.2d 168, 171, 335 Ill.App. 435.

²Sinclair v. Allender, 26 N.W.2d 320, 325, 238 Iowa 212.

³Pratt v. Board of Ed. of Dist. No. 61, Kankakee County, 63 N.E.2d 275, 281, 326 Ill.App. 610.

⁴Wise v. Delaware Steeplechase & Racing Ass'n, 39 A.2d 212, 217, 28 Del.Ch. 161.

⁵Kornbau v. Evans, 152 P.2d 651, 656, 66 Cal.App. 2d 677.

in his own name. In the agency arrangement, the agent represents and acts for the principal. Where a trust may ordinarily be terminated only by fulfillment of its purpose, an agency may generally be revoked at any time.

A somewhat similar factor distinguishes the bailment and the executorship from the trust. In a bailment one person entrusts another with property but does not vest title to the property in the other. Thus, a trust company may act as a bailee, agent, or custodian for another's securities. Similarly, the executor of a will cannot assume the role of a trustee; unless otherwise specified, the executor's duties involve only the distribution of the decedent's estate after paying the debts.

THE TRUST RELATIONSHIP

The trust as it exists today has been called the fiduciary trust. That name distinguishes the trust that originated in common law from the industrial or business trust. The latter describes a combination or cartel of firms or corporations that have formed an alliance for the purpose of controlling competition and dominating entire markets. These combinations are not trusts at all, and the popular use of the word should not be mistaken for a legal trust.

As a legal entity, the trust creates a fiduciary relationship, or a relationship involving custodianship or administration of property or money for another person. In establishing a trust, the trustor indicates a desire to place the legal title to property in some other person or persons, or in a corporation. When the trustee, the other person, agrees to accept such title, the agreement may be formalized in a trust instrument.

A trust in essence represents a long-term arrangement for disposing of property. For that reason, the trust agreement may specify how or by whom the trustee will be replaced in the event that he dies or is disabled before the trust period has ended. Thus, the relationship is preserved even though, as often happens, the trustor may never make the acquaintance of the persons who serve as second, third, or later trustees.

ANATOMY OF A TRUST

In a typical case, Uncle John gave his best friend, Mr. Brown, 1,000 shares of Triple-B Manufacturing stock. Mr. Brown agreed to

hold the stock in trust and, when necessary, reinvest it for the benefit of Uncle John's nephew Ronald and Ronald's three children.

The *trust agreement* specifies that Mr. Brown will give Ronald all the income accruing from the stock or from the property purchased at the time of reinvestment. Ronald is to receive such income as long as he lives. After his death, the property itself, whatever it may be at that time, will be turned over to Ronald's children.

Uncle John is the *trustor*, the person providing the property and creating the trust. Mr. Brown is the *trustee*; he assumes full legal ownership of the trust property—the stock—and becomes Uncle John's personal representative. As such, he has the power and duty to carry out the trustor's wishes as expressed in the trust agreement.

Ronald and his children are the *beneficiaries* under the trust. Ronald bears the title of *life tenant*, because he has the right to receive the income from the trust as long as he lives. His interest is called the *life estate*. His children are *remaindermen*, because they have a *remainder* interest—the right to the property when the life estate ends.

Unborn or unknown persons may be designated as beneficiaries. If Uncle John had indicated, for example, that all of Ronald's children who were living at Ronald's death were to be listed as beneficiaries, that term would include children not yet born when the trust agreement was signed. If Uncle John had declared in the agreement that the remainder should be paid to Ronald's wife, without giving her name, the remainderman might be unknown. The phrase "Ronald's wife" would refer to the woman to whom he was married at the time of his death.

The stock that Uncle John turned over to Mr. Brown constitutes the *corpus* (Latin for *body*) of the trust. It is also called the *trust property*, *trust fund*, or *principal*. In Uncle John's case the corpus was stock, but it could have been real estate, cash, a business, insurance, or other kinds of property. A trust fund may include any kind of property that can be owned, sold, or otherwise transferred from one person to another.

Which of the elements and people involved in Uncle John's trust are indispensable?

Every trust must have a trustor, a trustee, a beneficiary, trust property, and some form of trust agreement.

THE TRUSTOR

Obviously, no trust could have come into existence if Uncle John had not been alive and taken the initiative to establish the trust. In placing the legal title to the stock in Mr. Brown, Uncle John could have proved his desire to establish a trust by oral testimony, in writing, or by conduct. In deciding on proof of an intention to set up a trust, a court would give consideration to the words used, the circumstances surrounding the transaction, and the actions of the parties.

THE TRUSTEE

A trust also cannot exist without a trustee—in this case, Mr. Brown. In certain kinds of trusts, the trustor can serve as trustee, but there must be some person, or corporate entity, who has the right and duty to manage or administer the trust in accordance with the terms of the agreement.

THE BENEFICIARY

Under the definition of a trust, the trust corpus is held and managed for the benefit to someone who is usually neither the trustor nor the trustee. That other person, the beneficiary, is also essential to the existence of the trust. In some cases, the trustor might also be the beneficiary; but the trustee and the beneficiary must always be different people. As beneficiaries, Ronald and his children have equitable interests in the trust corpus. They may even be called the equitable owners of the stock.

Beneficiaries are called, technically, *cestuis que trustent* (pronounced “seti-kee-trust”). In the singular form, the phrase is *cestui que trust*. The shortened form *cestui que*, or simply *cestui*, is widely used.

THE TRUST PROPERTY

The trust property, or corpus, constitutes another essential element. Unless Uncle John had owned the Triple-B Manufacturing stock or some other transferable property, he could not have established the trust. His ownership or interest in the property might have been a future one; he could, for example, have created an insurance trust that would not have been funded—that is, received any property—until his death. At that time, the proceeds of his life insurance policies would have been put into the trust and become its corpus.

Legal theorists hold that the division of interest or title in the trust corpus, between the trustee and the beneficiary, represents an essential condition of a valid trust. Under that division, the trustee holds the legal title to the trust property and the beneficiary holds an equitable title. But the division remains an imponderable, even though its existence is acknowledged at law.

Uncle John could have established a trust by issuing a declaration in trust. In that case Uncle John would have become both trustor and trustee and retained legal title to the property as trustee. Ronald and his children, as beneficiaries, would have assumed equitable ownership.

Different types of trust are worded according to specific patterns; form trust instruments exist for the guidance of trust officers, attorneys, and others charged with responsibility for creating or enforcing trust agreements. But because both estates and networks of human relationships reveal endless diversity, most trusts have distinguishing characteristics.

A trust agreement between the person establishing the trust and the person or organization serving as trustee launches the modern trust. The agreement, a kind of contract, is all that is required. It need not even be notarized to become a legal entity. This holds whether or not the trust provisions take effect at once or only after the trustor's—or someone else's—death.

The trust agreement usually covers the essential details of what the trustee can or cannot do. Some states have laws that specify or delimit a trustee's powers and rights, but others do not. In either case, the trust agreement spells out what the trustee is to do. How he performs his functions, in brief, makes the trust effective or ineffective. His actions as trustee are undertaken in discharge of the trustor's wishes—or they contravene them.

The trust agreement exists as a formal expression of the understanding between the trustor and the trustee. A number of technical legal concepts are involved. For that reason, a lawyer who understands estate planning and probate should always participate in the preparation of a trust agreement.

THE TRUST AGREEMENT

Trusts may be classified according to the ways in which they are created. The trust agreement may be expressed or implied. In the former, the trustor manifests clearly, usually in writing, the desire

to set up a trust. The trustor does not need to use the word *trust*; nor does he have to notify the beneficiary or others that he intends to create a trust. The trustor *does* have to own the property with which the trust is to be created, and he must own it at the time the trust comes into being.

An implied, or resulting trust is based on an inferred or presumed intent of the trustor. This kind of trust comes into being as a result of the trustor's desire to create it, not through operation of the law. It arises sometimes as a remedy given to the trustor, or those entering claims after the trustor, when the purposes of a trust have been accomplished without exhausting the trust property. Typically in such a case, no alternative method of disposition of the property has been specified.

More frequently, an implied trust comes into being when a person disposes of his or her interest in property but does not dispose of the beneficial interest. No trust document exists. But the law presumes that the person wanted to create a trust. If, for example, John Action transfers property to Albert Baker but specifies that the income from the property is to go to Martin Cordery, a court may presume that Action wanted to bring a trust into being. Cordery becomes the beneficiary.

OTHER ASPECTS OF OWNERSHIP

It may be noted briefly that the trustor usually retains no ownership rights in the trust corpus unless he or she has reserved them specifically when drawing up the trust agreement. Thus, in most trust documents, the trustor retains the right to alter, amend, or revoke the trust being created. (The irrevocable trust represents an exception to that rule.) A clause giving the trustor the right to change the instrument does not keep the trust from being established. Nor does it affect the trust's validity unless and until the power is exercised.

LEGAL EFFECTS

Some fundamental legal effects are achieved through creation of a trust. (Some of these have been noted in the case histories in Chapter 1.) They suggest the reasons trusts are established in the first place. These effects exist apart from such advantages as

avoiding unnecessary taxation and providing professional assistance and advice. At least three categories should be noted: delay or control of property distribution, elimination of the need for guardianships in given circumstances, and establishment of a flexible, dependable system of administration and management of given types of property.

DELAY OR CONTROL OF PROPERTY DISTRIBUTION

The following examples suggest why the trust may offer a superior alternative to the typical will. When a will provides for outright distribution to a person's heirs, the distribution of the estate takes place as quickly as possible. "As quickly as possible" may mean anywhere from a few months to three or more years after death, depending on such factors as the complexity of the estate and whether the will is contested.

Assume for the sake of argument that one of the beneficiaries under a will is 78 and another beneficiary has just turned 21. Under the will, each of these two beneficiaries will inherit immediately after completion of the probate process. A strong likelihood exists that the property going to the older man will eventually receive inadequate attention and management. Over time, the value of that property may dwindle. Should the infirmities of age lead to legal incompetence, a court will have to appoint a guardian, who might then, and only then, be empowered to sell or mortgage the property. The guardian might be asked to reinvest the proceeds from a sale.

The property received under the will by the man of 21 may be dissipated quickly. No one would dispute the young man's right to spend his inheritance in his own way and at his own speed, but his capacity to manage money is suspect and the testator may want to avoid the risk that such improvidence might waste the estate he has built over many years.

As another example, assume that the mother and father of a young family die leaving a considerable estate. The property inherited by the children under the parents' wills would have to be kept separate and administered separately and the children would have to be cared for until they become adults.

In these two examples, trusts could have solved the problems arising under the wills. In particular, trusts offer a means of

avoiding the problems that arise when beneficiaries are too young or for some other reason not able to handle their inheritances at the time of a testator's death. Two types of trusts are particularly relevant here.

The flexible trust. Under a trust, a child may receive all the support needed for his or her maintenance and education, but the trustor can specify that the principal is to be held until the beneficiary reaches the age of 25 or 30. Often a trustor will provide for installment distribution: A portion of the trust principal will go to the beneficiary at a certain age—say, 25; another portion may devolve on the beneficiary at age 30; and the balance at age 35. By that time the beneficiary has, presumably, gained the wisdom to manage the resources. In this way, young people can receive the benefits of an estate even though they do not take control of it.

The lifetime trust. The lifetime trust provides for payments from the trust estate to one or more beneficiaries until they die. Arguments for and against the practice of settling lifetime trusts on young people have never really answered all the possible questions. Certainly, the person considering such a trust should think carefully about the potential effects.

Where a lifetime trust exists, the key question that may arise is: Will the trust do more harm than good? Those who would argue against lifetime trusts contend that the net result may be overprotection of the beneficiary. The trust ensures a dependable source of income; but uncertainty stands as a factor that motivates us to work, to create, to provide for ourselves and our families. To remove that uncertainty may actually prove harmful. A valuable wellspring of personal motivation may be eliminated.

AVOIDING GUARDIANSHIP

Guardianship is designed to provide a legal overseer for those who are too young or those who are unable because of mental or other incapacity to manage their own affairs. A probate court—usually located in the county where the ward, or person to be placed under guardianship, lives—appoints the guardian.

Two types of guardianship are common. The *guardian of the person* has the responsibility for caring for the ward—for his or her schooling, clothing, medical care, daily upkeep, and so on. The

guardian of the estate has the task of controlling and managing the ward's estate for the ward's benefit.

In appointing a guardian, the court generally places great stress on the manner in which the guardian's duties are to be performed. If the guardian is not a professional, the court will require that he be bonded. The bond serves as a guarantee of faithful, conscientious performance. The guardian then reports at least annually to the court, explaining his actions and decisions. Between reporting visits, the guardian may approach the court for release of funds for special purposes.

Guardianship of an estate entails relatively heavy costs. Bonding involves a substantial expense, in some cases amounting to almost .5 percent of the total value of the estate, or of the estate portion for which the guardian is responsible. The costs of dealing with the probate court, of ensuring legal representation, and of other incidentals add considerably to the costs of guardianship.

A trust eliminates the need for court-ordered guardianship of the estate, because the property placed in most trusts is not subject to the probate process. The trustee has already assumed the responsibility of administering, investing, and distributing the trust property.

Some incidental but important advantages derive from avoiding probate and its guardianship procedures. The trust, for example, makes possible better handling of children's inheritances. Even where the trust defers a child's assumption of title to the estate, or to a portion of it, the trust can confer a full right to withdraw funds at any time after the young person reaches the specified age. The beneficiary can thus decide for himself or herself when the trust is no longer serving a worthwhile purpose.

Another advantage of avoiding probate is that the trust makes possible more equitable treatment of children. Where all of the parental estate is retained in a single fund until the youngest child reaches a specified age, the trustee can usually make distributions in the interim according to need. The need may be medical, educational, artistic, or professional. If a younger child receives funds before the date of final eligibility, such distributions may be treated as advances on his or her ultimate share.

Even where a trust has been established, younger children or children requiring special care may have to be placed under non-

court guardianship. Again, the trust makes possible flexible arrangements. Because the trustee will oversee and manage the estate, a guardian may be selected on the basis of an ability to make a good home for the child without regard to the person's ability to manage finances and property. A trust also makes it possible, even in those states requiring that guardians be state residents, to engage a nonresident trustee to administer the child's equity estate.

FLEXIBLE ADMINISTRATION

The principle of trust flexibility does not apply only in the area of guardianships and special arrangements for beneficiaries. The principle has effect across the entire gamut of activities that may be undertaken by a trustee.

The only proviso: The trustee must have flexibility under the laws of the state in which he is located or have been granted a degree of flexibility by the trustor in the development of the trust agreement.

Efforts to read every detail of the future are inevitably doomed to failure. Thus, estate planners seeking to solve problems that may not arise for many years face myriads of questions. Will all your children survive to reach their majorities? Will all of them want to go to college? Should your son have funds for the purchase of a new car? Your daughter wants to become a pianist; should she have the funds needed to pursue her ambition? The answers may defy formulation. At any time, in any place, estate planning represents a difficult challenge.

When drawing up a will, you may actually be attempting to solve all such problems before they arise. Your will stands as your last word, your final testament, and must be carried out by your executor after your death exactly as its terms specify. Yet you were unable to select the date of your death; conditions may change between the day of your death and the time of execution of the will.

Under an intelligently drafted trust agreement, by contrast, the trustor can guarantee flexible approaches and solutions to future problems. For example, the trustee may be given, among other broad powers, the right to invest in whatever will most directly

benefit the trust. The well-conceived trust agreement does not restrict the trustee to purchases of a certain company's stock or a given type of security; rather, the trustee is given discretionary authority and latitude.

Trust practices have changed in this regard over the past half century. Before World War II, particularly during the 1930s, trust agreements typically placed severe restrictions on the investment activities of trustees. Purchases of common stocks were ordinarily prohibited. Too many persons remembered the stock market crash of 1929.

Since World War II, as property values and the cost of living have risen meteorically, professional estate planners have learned to view the erosive effects of inflation as the great danger facing estate security. Older trusts that were bound by excessive restrictions were seriously hampered; many lost value as the buying power of their dollars decreased. Thus, the new spirit that let more flexibility into trust documents became general.

YOU AND YOUR TRUSTEE

You have sketched out your Grand Trust Plan. You know approximately how much you own and how much you want to place in trust. You have listed your potential beneficiaries and know how much each of them means to you and what you'd like to do for them. You have decided to start with a marital trust.

You have a horrible thought: You need a trustee.

Who?

Charlie Palmer, over at the bank? He's done tons of work for you and with you over the years. Mike Dowling, your brother-in-law? You and he have had a special relationship for years. Jim, your brother?

One thing is obvious: Almost anyone can serve as a trustee. But another thing is equally obvious: You need the right trustee or your Grand Trust Plan could fail, with everyone mad at everyone else.

SELECTING THE TRUSTEE

You are, of course, right. The trust agreement involves, most immediately, you and the trustee. Failure will be writ large across

the front page of your trust instrument unless you select the right person *now*. You review. . . .

The trustee will hold ownership of your trust property and management rights—that is, invest-reinvest powers—over that property. He has the duty to use the property exclusively for the benefit of your beneficiaries. That rules out his own favorite gold-mining stocks, in all likelihood. The trustee will be entitled to a fee for his services—a fair one—and no other remuneration. He has to be loyal or his other magnificent characteristics will be meaningless.

Should you choose a person or a corporation as trustee?

In the end, you opt for a corporate trustee. You want the Cool Hand Luke approach, the expertise, the lack of self-interest, the formal files locked into the Trust Department at Pioneer Peoples and Trust Bank.

If you're thinking straight, you have selected Pioneer, for one reason, because it is close to home. You have had your lawyer prepare the trust instrument to make sure all legal technicalities are accounted for. You have checked arguments pro and con.

An individual trustee? The arguments that point to the desirability of choosing an individual as your trustee carry some weight. To cite just a few:

- An individual known to the trustor can bring a personal touch and understanding to the entire transaction. In the process the trustee may give the trustor confidence that his choice of trustee is a wise and effective one.

- A family member, relative, or personal friend can—although this is not necessarily the case—possess all the needed qualifications of a trustee, including investment expertise, accounting skills, and tax know-how. The choice of someone close to the trustor might be desirable because, in administering the estate and dealing with beneficiaries, the friend or relative can use heart; he or she can take care of the beneficiaries with personal knowledge of their idiosyncrasies, strengths, needs, and weaknesses.

- A personal contact may discharge his trustee's duties for little or no remuneration.

Obviously, any of these arguments could be rendered meaningless. The individual who is known to the trustor may have ulterior

motives, even though he has been a friend of the family for years. Those motives may doom the relationship to failure. The friend or relative may *not* have the necessary qualifications and may have to go through a learning process lasting months or years. Also, personal knowledge of the beneficiaries' idiosyncrasies can lead to biased or prejudicial decisions as well as to wise ones. In obtaining another's services in the important trustee function free of charge, you may be getting what you are paying for—nothing.

A corporate trustee? The considerations pointing to a need for professional help from the trustee seem far more convincing. Once again, a few can be noted:

- The range of duties that the trustee will be called upon to discharge requires a depth of knowledge and an expert's approach in a number of areas—investing, accounting, and law, to name a few. A bank trust department or other corporate trustee would either have such knowledge and skills available on its premises or would know where to obtain them.

- Corporate trust officers, remember, have investment information at their fingertips that individuals cannot obtain without spending a good deal of time pursuing it. To give one example, a personal trust officer receives daily reports on the performances of some 140 core stocks. Brokers and advisors have the specific task of counseling the officers on those core stocks on a repetitive basis. A larger list of some 200 highly rated issues is monitored periodically.

- The firm serving as trustee has staff members who have been trained to combine advice-and-counsel skills with a sympathetic ear. Learning about family situations through listening has become second nature to many such people. Their judgments can remain unclouded by personal bias. For example, a request for funds from a beneficiary can be assessed on its merits alone.

- The fees charged by institutions that act as trustees cover, as noted, a broad gamut of services. On that basis alone, the fees cannot be said to be exorbitant or exploitative.

- The professional corporate trustee offers continuity, stability, and reliability along with a staff whose aid will always be available. Trustors can be sure their estates will be administered in a businesslike way.

- If participation of a family member in the trustee's work is

considered important, the trustor can name a relative or friend as cotrustee. A surviving spouse can be named to serve in that role along with the corporate professional.

LOCATION OF THE TRUST

Common sense dictates further, of course, that the trust be located in a state that has some material connection with your estate. The location of a piece of property may emerge as the decisive factor. More typically, the residence of either the trustor or the trustee will affect the choice.

In a few cases, the laws of the state considered as possible locations for the trust may influence you. Each state has different laws governing the operations of trusts. These laws place various limitations on the powers of the trustee. They also limit the length of time during which the property can be held in trust. But nowhere can personal trusts, with the exception of charitable trusts, be established to last in perpetuity. In most states, trusts can be established to last a long time, however, usually for a period measured by the lives of a given number of people, or of a person (not necessarily a beneficiary), plus 21 years.

A trust, fortunately, can be moved. If you move from the harsh winters of the northern United States to the balmy climate of Florida, you can pick up your trust and move it with you. Such a change is called a change of situs. In this usage *situs* means the place where the active duties of the trustee are performed. As a precautionary measure, you would want to insert in the trust agreement a clause making such a move possible. The clause also gives the income beneficiary the right to ask the trustee to resign and nominate another trustee in the beneficiary's new community.

Numerous pitfalls have to be considered—and if possible avoided—where a change in the location of a trust is contemplated. For example, the trust must be recognized in the new situs as a continuation of the original agreement. If it appears that the trust, for whatever reason, will be viewed as having been terminated and a new one created, serious tax consequences could follow.

On the other hand, the reasons for moving a trust from one location to another can be compelling. A trustee may move to a new community, making a change of situs necessary, or trust

assets such as stock certificates may be moved from one jurisdiction to another. In the case of a trust with contacts or assets in more than one state, it may be found that tax or other advantages will flow out of a change of location. These aspects are summarized in the special list on the following page.

The importance of selecting the proper local court—the forum court—out of the courts that might have jurisdiction over the multistate trust cannot be overemphasized. The trustor in such a case should look ahead to the legal results to be achieved in tax and other areas.

Many cases point up the importance of selecting the appropriate trustee in the proper location. The following example serves as a caveat.

The Texas client of one attorney was determined to name a New York City bank as his trustee. Despite the attorney's warnings, the trustor went ahead with his plan. After the trustor's death his widow, beneficiary under an irrevocable trust, found it necessary to talk with the trustee from time to time. Her long-distance telephone bills became astronomical.

You as trustor could find it necessary to confer with your trustee on very legitimate questions, or your beneficiaries may want to. The complexity of the quarterly computer reports issued by banks may alone make consultation necessary. Many other problems may require face-to-face communication. Telephone bills aside, it may be unrealistic to assume that a trustor or a beneficiary could receive the same service from a trustee located in a distant city that could be obtained from a local individual or corporation.

YOUR TRUSTEE AND YOUR BENEFICIARY

The duties and rights of trustees and beneficiaries will be examined later in detail. For the moment it will suffice to note in broad outline the elements of the relationship that a trust establishes between a trustee and a beneficiary.

This fiduciary relationship begins with completion of the trust instrument or with the trustor's decision to establish the trust, and it continues until the trust expires. As noted, it can last 75 or 100 years—the ordinary span of a lifetime plus 21 years. In such a case, a succession of beneficiaries may be legally involved. For example,

WHEN CHANGE OF SITUS BECOMES ADVISABLE

A change of situs of a trust may become desirable or even necessary for both tax and nontax reasons. Some of the key reasons in both categories include:

Nontax Reasons

1. The income or principal beneficiary of the trust moves from one jurisdiction to another.

2. The trustee moves to a jurisdiction different from, and distant from, the original trust situs.

3. A new trustee in a new jurisdiction must be substituted for a former trustee.

4. In the old situs of the trust, currency devaluation, political instability, terrorist activity, communist takeover, or inefficient methods of doing business threaten the viability or security of the trust.

5. A new and different situs offers lower trustee commissions, custody fees, legal fees, and other costs of trust services.

6. Where the trust is revocable, it may become possible to avoid local laws of the trustor's community that impose unusual or unwarranted limitations on freedom of disposition.

7. A change to a new trustee in a new jurisdiction may enable the trust to sue or defend a suit in a federal court rather than a state court.

Tax Reasons

1. Change of the trust situs—for example, from New York to Florida—may avoid local state and even city income taxes on ordinary trust income and capital gains of a resident.

2. A change of situs may be justified if the new state has a state income tax but exempts the trust from local income taxation on the grounds that it is a nonresident trust.

3. A change may end overlapping of separate state taxes imposed on trust income in one state and on trust principal in another state. After the change the trust situs tax situation fits that of the beneficiary.

4. A foreign trust situs may be changed, where a U.S. citizen is the beneficiary, to avoid application of the anti-foreign trust and accumulation provisions of the Internal Revenue Code (IRC), in particular the discriminatory clauses of the Tax Reform Act of 1976. The change would place the situs in the United States.

5. A stateside trust situs may be changed to a foreign tax-haven location that imposes low or no taxes on trusts. This would avoid federal and state taxes on capital gains, ordinary income, and income accumulated and distributed in later years; federal and state gift, estate, and inheritance taxes; and so on. Extreme care should be taken, in the case of a U.S. citizen, to observe all the IRC's disclosure and penal provisions.

Trustor Blue could leave property in trust to Beneficiary Black and a life estate to Black's son Charles; on Charles's death the life estate goes to Charles's son Michael (living at the time Blue dies), and the remainder to Michael's oldest son on Michael's death or when that son reaches the age of 21, whichever occurs later. Obviously, the trustee/beneficiary relationship in such a case could last 80 or more years. Throughout that period the trustee and his successors, whether individual or corporate, are bound by the terms of the trust agreement.

The trustee/beneficiary relationship places on the trustee a range of general and specific duties or obligations. The general duties include those that are imposed by law on all trustees. The specific duties are those that are spelled out in the trust agreement.

The trustor has wide latitude in writing the terms of the trust—and thus in establishing the trustee/beneficiary relationship. In setting down these terms, the trustor is actually deciding how and on what basis that relationship will proceed. The trustee may be given little discretion in administration of the property; he may in effect serve as a sort of agent who disburses funds to various beneficiaries. Or the trustee may have broad discretionary powers—for example, the right to distribute any portion of either income or principal as he sees fit.

The trustor may reserve certain rights to himself and in that process may limit the powers of the trustee. He may retain the power to administer the trust property or give that power to a third person or institution. The trustor may alternatively reserve the power to modify the trust agreement or to revoke it at a later date. At that time the trust property may revert to the trustor's ownership.

All such provisions in the trust agreement help define the relationship existing between the trustee and the beneficiary. Whether that relationship becomes a personal one depends, however, on other circumstances. A beneficiary may never meet the trustee, preferring to receive checks and remain personally removed from the details of the estate management and administration. But very often the beneficiary will come to know his or her trustee in the course of dealings that have importance for both parties.

The trustee may have to enforce unpalatable trust terms in

specific instances. Where a trustor has written into the trust agreement restrictions on the alienability of the beneficiary's trust interest, for example, the trustee may have to ensure that the beneficiary does not sell or encumber that interest.

A final point may be made. The trustee must know the beneficiary or have a specific method, laid out in the trust agreement, of ascertaining the beneficiary's identity. As indicated, no trust can exist without a beneficiary who holds an equitable interest in the trust property. This may be an income or principal interest; either is valid, and in either case the trustee is bound by law and by the trust terms to honor and protect the equitable interest.

Chapter 4

MAJOR CATEGORIES OF TRUSTS

For good reasons the trust has been called, variously, a crowning achievement of Anglo-American law, the most flexible method of disposing of an estate before death, and a kind of privacy insurance. The trust certainly represents a legal construct of immense utility value and flexibility. It guarantees privacy because it can eliminate the need for probate of a will, with all that that entails in terms of court records, reporting, and other public procedures.

As they have evolved in modern times, trusts have fallen into two basic categories: the *inter vivos*, or living, trust and the testamentary trust. The first of these is the more common. Property held in a living trust is not normally subject to probate. Thus, use of this kind of trust avoids the probate process for any property that is held under its terms at the time of the trustor's death.

As the name indicates, the testamentary trust is created as part of a will. Property placed in a testamentary trust passes into the trust at the testator's death, without going through the probate process.

LIVING TRUSTS

The living trust has in recent years come into vogue as one means of providing the trustor with expert management assistance. The living trust that is established for this purpose solves the problem that many persons with substantial estates face: how to keep up with investment news while continuing with one's own work. In such cases, the trustor has usually amassed an estate including a significant amount of investment property.

Living trusts can do much more, however. They can provide the solutions to lifetime transfer problems. Consider the challenges facing the following persons.

- Tom Ellis, known as Mr. Thrift to his associates, knows that, unless he does something before he dies, his moderate estate will go through probate. If he could have his way, a large part of this estate would pass directly to his heirs. The devolution would be accomplished in the shortest time and by the least expensive method while avoiding probate proceedings.

- Jim Holleran, Mr. Successful at his exclusive club, has built a major public relations concern while acquiring interests in a number of companies. He travels constantly and thus has little time even to think about, much less manage, his portfolio of investments.

- John Gillie, father of six, thinks of himself as Disappointed Father of the Year. Of his six grown children, one is a wastrel who cannot hold a job or stay in one place. Gillie has long since stopped speaking to this son; their languages sound the same but have different meanings. Gillie would like to cut the prodigal son out of his estate, with the son's express consent, while avoiding all the hometown publicity that might accompany probate of a will.

- Emil Callison, who tries to plan everything ahead, has three children. The oldest of Mr. Plan Ahead's youngsters is only six, but already Emil is wrestling with the problem faced by any man who considers college important: how to provide for the postsecondary educations of all three children. He has some stock holdings and ranks in the 60 percent tax bracket.

- At 32, Georgia Everson has become Mrs. Real Estate Investor by consistently and successfully buying and trading real property. The real estate holdings are scattered across many states. On Georgia's death, proceedings will have to be held in each of the states in which property is located. Georgia would like to dispense with all such administrative processing because of the time and cost involved.

- Mary Cortese, Dutiful Daughter and sole support of an aging mother who can no longer work, contributes \$7,000 annually to buy her mother food and keep her warm and happy. An executive with a major international telecommunications firm, Mary has property that would yield the needed \$7,000 annually. Since Mary's income places her in the 50 percent bracket, she needs a

way to have the \$7,000 taxed to her mother without giving her the property.

- **Worry Wart Albert Strunk** fears that the plans he has so carefully laid for disposition of his estate by will cannot possibly accomplish what he wants done. He senses that his last will and testament will neither provide for his wife quickly nor do right by his four children. He needs a technique that will give him a better overview today of what will happen after his death—sans probate and its costly and complex procedures.

- **Ephraim Johnston**, the original Cautious Parent, hankers to find the perfect means of dividing up his not inconsiderable estate before his death. He has a wife, three children, and four other relatives of varying degrees of kinship for whom he would like to provide. He has little faith in the ability of any of these would-be heirs to manage large sums of money. He worries particularly about his own children.

In each case, the answer to the problem lies in the living trust.

LAW AND THE TRUST AGREEMENT

Because state laws govern the operations of trusts, each trust agreement must be drawn up with the local law in mind. Within those limitations, the trustor can make his own rules regarding the future functioning of the trust.

The trustor has some basic obligations in creating a trust. He states the purpose of the trust, determines the amount and type of property it will contain, and specifies how long the trust will last, tying that date in most cases to an event that must occur at some time in the future. He picks the beneficiaries or provides a means by which they can be identified. For example, he may indicate that his son Bert and all of Bert's children are to be beneficiaries. Some of Bert's children may not have been born, but they nonetheless qualify as beneficiaries.

The trustor has other options when preparing a living trust agreement with the aid of a lawyer. He can list the conditions that a beneficiary must fulfill in order to qualify to receive portions of either interest or principal and may specify, in this connection, that some children beneficiaries would not be entitled to shares of the trust principal until they had reached certain ages. These beneficiaries might also have to achieve certain income levels before becoming entitled to their shares. The trustor can provide

for alternative dispositions in case the trust conditions are not met and also for changed circumstances—the death of a primary income beneficiary, for instance.

Sober with power, the trustor can and should set the conditions and rules under which a trustee will function. He names the trustee and makes the rules as generous or as picayune as he wishes. Generally, the trustor gives the trustee some latitude, or discretionary power; but the trustor makes the trustee an extension of himself by giving the trustee management and disposition powers comparable to his own as these existed before the trust agreement was drawn up.

The living trust becomes more than a means of making a lifetime transfer of property. It creates a specific estate and serves as a mode of postmortem estate transfer.

The rules and conditions stated in the living trust agreement comprise a tiny world of law that governs disposition of a specified amount and kind of property. The trustor has drawn up these rules and conditions for known purposes and may have many different goals in mind for the single trust instrument. In other words, the trust may be created to achieve a number of different purposes at the same time.

Whether or not the living trust actually does what the trustor wants it to do depends on a number of factors. The trustor must know in concrete terms what he wants to accomplish. His lawyer must be able to devise the proper provisions and terminology—a key reason for utilizing a lawyer's help in the first place.

The trustor should have at least a general understanding of what the trust can do and how it can do it. He should have a broad idea of the kinds of trusts that can be created. Basic data on the opportunities provided by the living trust for income and estate/inheritance tax savings should be part of the initial briefing. The trustor's primary purpose may, as will be explained, focus on tax savings.

The trustor may want to study wordings. Some variant forms of the living trust are discussed in the next chapter. A sample living trust agreement appears at the end of the book.

PURPOSES OF A LIVING TRUST

The trust has been described generally as a way of supplying a new element essential to the proper care, management, or use of

property. The element may be needed because of the trustor's or beneficiary's character or situation. For example, the trustor may be unable, for lack of time, to administer his property, or a beneficiary may be an infant at the time the trust is established. A living trust may be created where physical capacity, mental capacity, thrift, interest, maturity, or experience is lacking. Many other types of conditions may obtain.

The purposes for which the trust is established relate to the trustor's own benefit in many cases. Thus, a trust may be set up by written agreement, by declaration, or by written agreement and declaration combined to take effect during the lifetime of the trustor to accomplish any of the following purposes:

1. *To build an estate.* A young man "on his way up" may create a small living trust and add to it over the years. His goal is to build an estate; typically, this young man will be pursuing a career that does not involve investment of funds or the management of property.

2. *To eliminate the burden of property management.* The living trust can give the trustor, young or old, the freedom to devote himself to business or a profession without interruption or distraction. The trust accomplishes this purpose, as noted earlier, by shifting to the trustee the multiple responsibilities connected with property management.

3. *To develop an estate independent of a business.* A man going into business for himself may create a trust as a means of ensuring that he will not be risking everything he owns as he develops his new enterprise. Or a woman already in business decides that, instead of plowing all her profits back into the business, she will set up a trust estate separate from the business. In both cases, the trustors are protecting themselves and their heirs.

4. *To obtain expert administration and management of property.* As with purpose 2, this goal relates directly to the trustor's desire to free himself of the responsibility for property management. But in this instance, an older person will usually be involved. He will create the trust because retirement is approaching; the trustor will be seeking the freedom to travel, to pursue a hobby or avocation, or to launch a retirement business without facing the need to invest funds or administer a possibly complex estate.

Clearly, any or all of the purposes noted may be combined, since a trust will frequently accomplish a number of goals. That rubric

applies also where the trustor is considering a trust whose essential purpose is related to the welfare of his or her family:

1. *To provide for a spouse.* To achieve this goal, the trustor may create a living trust with enough property to yield income adequate to cover both family expenses and the spouse's personal expenses. In so doing, the trustor may establish a more satisfactory atmosphere than would be created by giving the spouse a periodic allowance; the word *allowance* itself may raise a spouse's hackles.

2. *To provide for a son or daughter.* Rather than make an outright gift to a son or daughter, a parent may set up a living trust. The child may be physically incapable or mentally incompetent, but many living trusts are established by parents for children engaged in professions or businesses that are foreign to the investment of funds or property management.

The high incidence of divorce in the United States suggests that long-range wisdom may make a living trust the most appropriate method of providing for a child. In the event a marriage ends in divorce, the outright gift could be lost to the child forever. If not already dissipated, it may be taken by the former spouse. But contrast, the trust established by a parent for a child would survive the divorce and continue to inure to the child's benefit.

A living trust can of course be established for persons other than spouses and children. These others could include parents, brothers and sisters, more distant relations, and friends. Some of the important purposes that might be served by creating a trust either for members of the nuclear family or for others are:

1. *To supply an absent element of skill or personality in the care, management, or use of property.* The situations in which such a purpose may be pertinent are countless. The trustor may have a relative or friend for whom he wants to provide while the trustor still lives; the person may be physically or mentally handicapped, unable to manage money, or uninterested in making investments.

2. *To provide a go-between.* For whatever personal reasons, valid or invalid, the trustor may want to achieve distance between him- or herself and the beneficiary. In one actual case, a group of former students living in various parts of the country set up a living trust to care for a former teacher. The trustee became the students' representative.

In a second case, a widowed mother placed almost all of her estate in a living trust so that her profligate son could no longer

importune her for money. In this instance, the widow made the trust irrevocable, specifying also that the income from the estate would be paid to her for life. After her death, the income from the estate was to be paid to her son, with a protective provision and a provision that the principal be used at the trustee's discretion.

3. *To familiarize the trustee with the estate and the family.* A living trust makes it possible for the trustor to try out or introduce the trustee to his estate and the members of his family. The trustor may plan later to make the trustee his executor. The same trustee may be named to become the trustee under the will.

The manner in which the trustee administers the trust estate can provide the trustor with various kinds of information. The trustor can ascertain whether the trustee can act dispassionately vis-à-vis the family members or whether the trustee has the ability to invest money wisely. In the dealings between the trustor and the trustee during the trustor's lifetime, the trustor can gain familiarity with the details of property *not* included as part of the trust property. This will help the trustee who becomes executor of the trustor's estate.

REVOCABLE AND IRREVOCABLE TRUSTS

The terms *revocable* and *irrevocable* are used most frequently with reference to living trusts. When the trustor retains the power to terminate the trust, or to alter or amend it, the trust is automatically classified as revocable. Where no such powers are retained, and where the trustor under the terms of the trust agreement cannot terminate or alter the trust provisions, the trust is considered to be irrevocable.

A trust agreement might not specify whether the trust is to be revocable or irrevocable. In such a case, the laws of the state in which the agreement was drawn up will determine the question of revocability. In a few states, a trust will be presumed to be revocable unless the instrument contains a provision making it irrevocable. In most states, however, the reverse is true: The laws assume that the trust is irrevocable if the instrument is silent on the question of revocability. The trustor and the person drafting the trust agreement should thus ascertain first what the laws of the state of domicile specify. Then they should decide what they want to say on the subject of revocability.

A revocable trust has many of the characteristics of the bequest

made under a will, with one key exception: The revocable trust can be established in such a way as to remain free of probate. The irrevocable trust has been compared to an outright gift. This trust cannot normally be amended or abrogated by the trustor; yet it does offer more flexibility than the gift.

The two types of trusts come under different tax regulations. An irrevocable living trust is not generally held to be a part of the trustor's taxable estate if the trustor has not retained the right to receive trust income or otherwise control the trust. A revocable living trust would generally be included in the trustor's taxable estate. Depending on the powers reserved, the trustor might under the Internal Revenue Code be considered the owner of the trust.

Every person contemplating creation of a trust faces—or should face—the question of revocability. But this is not a simple yes or no question: Shall this trust be revocable or irrevocable? Rather, the potential trustor must consider whether at some future date he might want or need to revoke the trust agreement. With revocation, of course, the trustor would resume ownership of the trust property. The alternative is to surrender forever the right to terminate the trust and take back the property.

The revocable and the irrevocable trust have advantages and disadvantages. Some of these will be discussed in the following sections. The tax factors will be discussed in specific terms in a later chapter.

The revocable trust: advantages and disadvantages. It should be understood that the revocable trust has major benefits despite the tax liabilities. Some of the nontax advantages are:

- The provision of professional investment, record-keeping, and reporting assistance for the surviving spouse and the children until they outgrow the need.
- Improved handling of children's inheritances, as noted in Chapter 3.
- Protection of a beneficiary against his creditors, including an alimony-seeking spouse, and in many cases against his own spendthrift tendencies.
- Avoidance of probate expenses and possible problems if the beneficiary becomes incapacitated or dies.

- Retention of the right to increase or decrease the size of the trust corpus.
- Continued control over the trust in other ways, to the point where new terms can be specified, beneficiaries can be changed or added, more or less liberal use of the trust corpus can be programmed, and a trustee can be removed or another added.
- Retention of the right to make the trust irrevocable at some time in the future—for example, where the trustor is planning on entering a risky new business and wants to protect the trust property against creditors.

Other advantages reflect the generally advantageous aspects of the trust as a legal concept. In more specific terms, if a trustor of a revocable living trust moves to another state, less likelihood exists that the entire trust agreement will need to be rewritten. In such a case, the agreement may comprise an entire estate plan. Typically, a codicil to the agreement, or what is called a “pour-over” will, suffices to adapt the agreement to the laws of the new state. The pour-over will has the effect of moving property in the decedent’s probate estate into the trust corpus.

There is also an ancillary advantage. The revocable living trust can be created, as indicated, to relieve a trustor of the burden of managing property or a business. (The case of Mr. Successful at the beginning of this chapter serves as a case in point.) Revocable trusts of this kind, where the trustor is also the beneficiary, have proved especially useful to the owners of small businesses who are considering retirement. The owner transfers the business to the living trust. As long as he lives, the trustor continues to receive income from the business. After his death, the trust remains in force; the trustor’s surviving family members become the beneficiaries. The trustor has provided for professional, experienced management while he remains alive, which will continue without interruption on the trustor’s death or incapacitation.

Funding flexibility gives the revocable living trust still another plus. Funding refers to the act of placing assets in the trust. Flexibility can be ensured because the revocable living trust can be funded immediately on creation of the trust or later, when funds become available. Alternatively, the trust can have both funded

and unfunded portions. A trustor can place part of his estate in trust, funding that part, and at the same time provide that the proceeds of life insurance policies or employee death benefit plans are to be paid into the trust after his death.

An unfunded portion of a trust estate can also receive property under a pour-over will. Such a document, drawn up in conjunction with the trust agreement, specifies that property owned solely by the trustor will be moved into the trust corpus after his death.

An unfunded trust has been called a "dry" trust. The document that creates such a trust can be extraordinarily comprehensive. Where, for example, all life insurance, pension, and death benefit proceeds are made payable to the revocable trust, it is no longer necessary to make certain that all the insurance beneficiary forms have the correct contingent beneficiary designations and simultaneous death presumptions; these can all be covered in the trust agreement.

That agreement can also, in establishing a funded/unfunded trust, provide for great flexibility in investments and invasions of principal in case of need. The rule that such a document can be changed at a later date still applies. Making insurance and pension benefits payable to the trust, and not to the estate, means that these benefits will not be needlessly subjected to the claims of creditors or to higher estate administration expenses and inheritance taxes.

The revocable trust also has definite disadvantages. As mentioned, it is generally included in the trustor's taxable estate. For income tax purposes, a revocable living trust is known as a grantor trust, and all trust income is usually taxed to the trustor just as if no trust existed. Thus, the trust established primarily to avoid taxes should be irrevocable or have special provisions that make tax avoidance possible.

The irrevocable trust: advantages and disadvantages. The advantages of an irrevocable living trust also reflect for the most part the advantages of trusts in general. Some advantages have been cited. An irrevocable trust divorces the trustor and, if desired, his spouse from the potential or actual importunities of a son, daughter, or other beneficiary. The same trust may protect the trustor against the danger of infirmity in old age or against defects of the trustor's character.

A case illustrates what can happen. Trustor Abe Treadwell created a living trust for his own sole benefit for life. After his death, the trust property was to go into his estate. The trust instrument made no mention of revocability. Later, Treadwell decided to revoke the trust.

On the surface, it would appear that Treadwell should have the right to revoke the trust as and when he wishes. But he was known to be a drunkard and spendthrift; he created the trust during a period of sobriety, for his own protection. He was actually protecting himself against the time when he might want money to spend unwisely. As noted, in a few states, the courts have decided that Treadwell could not terminate his trust even though he had been named sole beneficiary. But even in those states, if Treadwell and his trustee agreed to terminate the trust, it is difficult to imagine how any other party would have the right to intervene in court to prevent termination.

Can beneficiaries terminate an irrevocable living trust? Let us assume that Trustor Michaels has created a living trust for the benefit of son John and daughter Joanne for life. After the death of the survivor of these two, the trust property is to go to the heirs of John and Joanne in equal shares. Could Michaels, John, and Joanne terminate—not revoke—the trust?¹ It will depend on the laws of the state in which the trust was created.

A trustor establishing an irrevocable trust has a singular means of programming flexibility into the use of the trust property. This is called the power of appointment.

Most simply, the power of appointment gives the person receiving it the right to change or direct the distribution of the trust property without adverse tax consequences. The holder of the power can, in other words, select or change the beneficiaries or their interests.

The power-of-appointment trust will be discussed later, but let's consider a specific case here. Grandfather Jones established an irrevocable trust with property valued at \$200,000. He gave his son, the life estate beneficiary, a power of appointment. So long as the

¹Revoke refers to the power of the trustor to cancel the trust and take back his property. Terminate refers to the power of the beneficiaries to bring the trust to an end by the agreement of all parties concerned. Some states allow the beneficiaries to terminate the trust with court approval; other states prohibit termination.

son, Robert, could not exercise the power for his or his estate's benefit, the trust property would not be taxable to his estate. The power was conferred with such a provision: Robert could only *appoint* the trust property among his children.

Consider the effect on Robert's home life. Ten years after the trust was created, the family situation had changed. Robert's daughter was preparing to go to college and needed financing. Robert decided that his daughter should have a substantial share of the trust property so that she could continue her education.

Robert's only son had dropped out of high school. He had flouted his parents' advice and authority and was living the life of a beachcomber in Mexico. He came home from time to time, and on one such visit, he pointed out to Robert that he would one day, after his father's death, come into an equal share of Grandfather Jones's estate.

Robert told him then of the power of appointment. In fact, Robert could control the distribution of the trust estate simply by exercising that power. Robert quickly reasserted his authority as head of the family.

TESTAMENTARY TRUSTS

You can create a trust under your will by providing that a part or all of your estate will go to a trustee. That individual, or corporate entity, will have the power to administer and distribute funds from the trust estate to specified beneficiaries.

While not as common today as the *inter vivos* trust, the trust under will, or testamentary trust, represents an important trust category. For example, a man may leave his estate at the time of his death in trust for his wife's benefit rather than outright for her use. A young couple with little more than a future estate in life insurance proceeds may make companion wills leaving all their property to one another. If both die in a common accident or disaster, all their assets are placed under the care and responsibility of a trustee for the support of their minor children.

The testamentary trust has many of the characteristics of the living trust. No testamentary trust can be established unless it has the five basic elements of a trust: a creator or trustor, a trustee or trustees, a beneficiary, property, and trust terms. A testamentary

trust may come into being even if the trustor does not use the word *trust* in the will: This occurs when the trustor shows clearly his intent to create a trust that is to take effect after his death.

A testamentary trust cannot become effective until a trustee is named. Where the trustor does not designate a trustee by name, a trustee will usually be appointed by a court. A general rule holds that a trust cannot fail for lack of a trustee.

Two or more trustees may serve together in that capacity. Both individuals and corporations can act as trustees; so can any other group entity capable of owning property. Individuals or corporations can hold the title of trustee even if they cannot actually administer the trust because of legal or other disability.

As in other trusts, the beneficiary or beneficiaries may be persons, corporations, associations, units of government, or other groups of individuals that can own property. Even if a person is mentally incompetent or physically incapacitated, he or she can nonetheless be a beneficiary and enjoy the benefits of a trust. Such incapacity may provide a reason for establishing a trust in the first place.

The trust must contain property of some kind to become operative. But that property may be held under either legal or equitable interest. The proceeds of a life insurance policy, to be paid out on the death of the insured, can form the *res*, or property, of a testamentary—or living—trust. Any kind of property that can be owned can be placed in trust.

The terms of a testamentary trust are important. These terms must specify the duties and powers of the trustee and the purposes for which the trust has been created. Without such specification the trustee cannot function intelligently. The trustee will not, in some cases, know what he is supposed to be doing while serving as trustee.

THE TRUST AND YOUR WILL

You become a testator when you make out a will. In that process, probably with the advice of your attorney, you have to decide whether you want to create one or more trusts as part of the will. You have an alternative: to leave your entire estate to pass directly to one or more persons whom you will want to name.

You do not have to make a will; nor must you necessarily create

METHODS OF TRANSFER BY WILL OR TRUST

Property may be transferred by will in a number of different ways. The testator's choice of a single method depends on the goals he wants to achieve. Three of the most common ways are:

Outright. The testator simply leaves his estate outright to his wife. He expects that she, in turn, will leave it to their children at her death.

The irrevocable trust. The testator directs that all his property be placed in an irrevocable trust on his death. The income is to go to his wife for life. The property will be distributed to his children on her death or at some other future time.

The marital deduction trust. The testator directs that his property is to be placed in two equal trusts on his death. The income from both is to go to his wife for life. The wife usually has the right to specify how the property in one of the trusts is to be distributed on her death. The estate becomes eligible for the marital estate tax deduction.

Assume that the husband's estate has a value at his death of \$250,000, that his wife has no property of her own, and that the husband predeceases his spouse, dying in 1973. The tax effects of the three testamentary arrangements are:

1. *Under the outright method.* With the testator leaving all his property outright to his wife, the approximate death costs will be:

At the husband's death	\$21,688
At the wife's death	49,185
Total charges after both deaths	70,873

2. *Under the irrevocable trust method.* With the testator placing his estate in an irrevocable trust taking effect on his death, the approximate death costs will be:

At the husband's death	\$56,450
At the wife's death	None
Total charges after both deaths	56,450

3. *Under the marital deduction trust method.* With the testator utilizing the marital estate tax deduction in conjunction with trusts, the approximate death costs will be:

At the husband's death	\$21,688
At the wife's death	8,188
Total charges after both deaths	29,876

trusts under your will. In this respect, the trust and the will are similar. The privilege of making out a will, with or without trust provisions, can be taken away by a legislature; it does not rank as an inalienable right.

Why set up a trust under your will? The testator may take such action for the same reasons impelling a trustor to establish a living will. Primarily, perhaps, the trust under will provides a conscientious, able trustee, who can safeguard and manage the property more efficiently and wisely than the beneficiary could if the property had been left to pass directly. To ensure such administration, the testator may name one trustee, cotrustees with separate responsibilities, or a succession of trustees. Different trustees may be named for different parts of the estate.

A testator creating a long-term testamentary trust will typically give close attention to the task of naming successor trustees. A trust may have a lifetime of 75–100 years. The testator may want to keep the trusteeships in the family and will therefore name as first trustee a relative who is approximately the testator's age. The will may specify that one of the testator's sons is to become trustee on the death of the first trustee and that a grandchild should succeed in the event of the second trustee's death.

In all such cases, logic should prevail. The testator who names as executor a 78-year-old brother is probably ensuring that a new executor will have to be named soon. The executor, in brief, should be qualified by age as well as ability to take on his or her new responsibilities.

Assigning separate duties to two or more cotrustees, or naming separate trustees for different portions of an estate, can make sense particularly where the estate is very large. A testator who owns a business may name one trustee to run the business and another to manage securities and real property. Both jobs may require extensive time investments on the parts of the trustees.

In devising your will, consider all the people who could qualify as your beneficiaries. If you have a single competent beneficiary who does not need assistance, advice, or guidance in the administration of your estate, you may not need a trust at all. The same may apply if you plan to leave your entire estate to your family under your will. In other cases, family considerations dictate the trust as the logical method of providing for family members.

The family trust. The testator may have a number of reasons for deciding to create a family trust under his will. He may, for example, want to keep his house in the family and, if possible, occupied. His intention may be to keep the family together after his death by providing for the support of his wife and their children. This goal may be especially pertinent where the children are still young. The testator may also want to give his wife a measure of independence along with the right to exercise her own judgment regarding the children.

Family motivations can obviously rank high among those factors influencing will and trust decisions. The family home may point to a need for special arrangements. If it comprises a considerable part of his estate, the testator may fear that he will leave his wife with an expensive house yet without adequate income to maintain the residence and support the family.

If the family home is left to the widow and children as tenants in common, and if some of the children are minors or incompetent, the widow may face similar insolvable problems. Children reaching adulthood may want to obtain their shares of the value of the house so that they can buy their own homes and start their own families.

A trust may offer the best solution. The trustee can act on behalf of all the family members. The family can occupy the house until a family home is no longer necessary. Then the trustee can dispose of the residence and convert the proceeds of sale in the best interests of the family and the estate.

Releasing the widow from possibly onerous duties is another valid motivation for creating a trust under will. Without a trust, if the widow receives the estate, or part of it, outright, she may as the surviving head of the family have to assume major business, financial, and investment responsibilities—a challenge her experience may not qualify her to face.

Testamentary trusts, like inter vivos trusts, make possible special provisions for the care of children. Extraordinary medical expenses may have to be met, or college tuition paid. The testator's widow may be given power to use the income *and* the principal from the trust estate at her own discretion.

Nonfamily beneficiaries. Beneficiaries outside the testator's immediate family may include almost anyone with whom the creator

of the trust has had dealings during his or her lifetime. Wealthy men and women frequently draw up wills under which they create trust funds for servants, old friends, persons who have performed special services for them, or even strangers with whose specific needs they sympathize.

Again we can draw a parallel to living trusts. The testamentary trust that has nonfamily beneficiaries generally seeks to protect or safeguard the trust corpus by bringing a moderating element into the situation. For whatever reason, the testator may be seeking to compensate with a trust under will for:

- A lack of physical capacity to care for and manage property of one kind or another.
- Mental incompetence that equates with actual, not only legal, inability to manage or use one's own property.
- A lack of thrift or of wisdom relating to the use of money or property.
- A lack of interest in the mundane details of managing and, possibly, investing in and administering property.
- A lack of maturity, a common situation where minors are concerned.
- Inadequate experience, which may exist with members of a testator's family as well as with persons outside the family.

THE TRUST TERMS

Because the testamentary trust has immense flexibility, the trustor or testator will have to become involved in the creation of the trust terms. Unless the trustor does so, the trust under will may fail to achieve its intended purpose. The terms not only lay out the duties and powers of the trustee and the rights of the beneficiary, they also, and very importantly, deal with questions relating to trust income and principal.

Income. In creating the terms that specify what is to be done with trust income, the testator has a number of options. Some of the more typical solutions include the following.

Under the terms of the will/trust instrument, the testator may provide that the income from the trust estate will be paid to the beneficiary as it is received. Obviously, such a provision virtually ensures that the income payments will be irregular as regards both

timing and amounts, although such payments are made at least annually.

The trustee may also, when carrying out such testamentary terms, have to budget his operating expenses. Yet the nature of the trust property may make payments “as and when received” the logical approach. In the case of a farm or a commercial building, rental payments may arrive at approximately the same dates from year to year. Thus “as and when” payments may impose no special hardships.

The testator may alternatively specify that the beneficiary is to receive income payments when he calls for them. If the beneficiary is known to be thrifty, such a clause may be the most appropriate. The trustee may accumulate the income or even invest it between visits from the beneficiary.

A spendthrift beneficiary presents the trustee with a complex of very difficult problems. The beneficiary may, for example, make repeated visits to collect trust estate income or constantly bother the trustee for additional funds. A clause specifying that income be paid out “as and when” requested by the beneficiary may thus ensure the trustee’s continuing dismay.

Another option is for the terms of the will to specify that the income from the trust estate be paid out to the beneficiary at the trustee’s discretion. Payments may then be made when the trustee believes they are most needed or will do the most good. Income payments may be withheld when they are not needed, to form a reserve or nest egg for use when the need is greater.

Depending on the circumstances, payment of the income from trust property at the discretion of the trustee may have good or unfortunate effects. A beneficiary who is attending high school at the time of the testator’s death may appreciate having the income build up until he or she needs it for college. But in other cases, an indifferent or inefficient trustee may do the beneficiary a disservice by paying out income at the wrong times.

A fourth alternative is for the will to provide that the income from the trust estate be paid out at regular intervals. Under such circumstances, the beneficiary can usually establish a budget and account regularly for his expenses. The trustee may also find his bookkeeping simplified.

Whether payments are made monthly, quarterly, half-yearly, or

on some other schedule will depend on the trustee and the beneficiary. The trustee may have the latitude to decide the payment schedule, or he may set up that schedule in consultation with the beneficiary. Both may believe that periodic payments may fail to provide for emergencies. If such emergencies are possible, yearly payouts might be spaced too far apart. The tendency today is to specify that payments be made quarterly, or even irregularly—for example, when bills for a child's tuition fees come due. In most cases, the terms of the trust *and* the needs of the beneficiaries determine the frequency of payments.

Principal. The testator has similar options when devising the terms of his will insofar as these apply to distributions of principal. The testator will first have to decide whether any such payments are to be made. A second decision is whether the beneficiary is to have access to the entire principal or to portions of it. In the former case, removal of the entire corpus of the trust estate would terminate the trust.

Some psychological as well as practical factors may become important. Would the beneficiary feel more participant in the trust arrangement if he had authority to request—and receive—portions of principal? Would a widow faced with the problems of raising a family after her husband's death be more confident of her ability to survive if she had access, as needed, to portions of the estate principal? Would an improvident beneficiary wear out his welcome in the trustee's office and make the trustee's life difficult?

All such questions, and many others, require answers. The testator creating a trust under a will may be concerned with the need to treat several or many beneficiaries fairly. That concern may suggest solutions to questions arising during the development of specific terms.

As a general rule, the trustee should have some latitude in disbursing portions of principal. When inflation threatens to reduce the income—actual or in terms of buying power—a will that provides for additional assistance may become necessary. For example, a widow may start with an income of \$18,000 under the terms of a testamentary trust. In a few years, the buying power of that sum may have shrunk by one-half. The trustee with discretionary powers could in such a case restore the purchasing power of the widow's annual income. In so doing, however, the trustee

could also defeat the purposes of the trust terms. With authority to pay over or apply principal, in addition to income, the trustee could misjudge the beneficiary's needs, the length of the trust, or the earning power of the trust property. The trust estate could in consequence be depleted well before the trust has accomplished its goals.

A second general rubric may be noted: The trust terms may give both the trustee and the beneficiary the power to draw from the principal. A beneficiary may have authority to take a stated amount or percentage each year; the trustee may have a correlative authority to pay out or apply a stated amount or percentage.

The overall goal cannot be neglected in the will-drafting process. The testator establishing a trust under will should keep the interests and needs of the beneficiary or beneficiaries in mind and seek ways in which to set down a document that will meet the needs and serve the interests.

Duration of the trust. The trust terms also specify the period of time during which the trust is to operate. For the most part, the trust constitutes a long-term approach to estate administration and management. The general rule regarding duration has already been noted: A trust can normally have a life lasting through the lifetimes of a reasonable number of persons alive at the time the trust was created, plus 21 years. Some states specify by statute that only two lives may be used as the gauge of duration. In these states a trust can last through the lifetimes of any two named individuals plus 21 years. At least one state, Louisiana, allows a trust to continue through the lifetime of *one* person only.

The laws on duration have an obvious purpose. They are designed to limit the trust period to that stretch of time over which a testator can reasonably foresee the needs of the beneficiaries. The key question is not: How long *can* the trust legally continue? But rather: In the interests of the beneficiaries, how long *should* it continue. The question may, of course, be phrased differently: How long *may* the need exist to separate the legal and equitable interests in the trust property?

For instance, a family trust will probably have utility value only so long as the need to hold the family together survives. Afterward, liquidation of the trust may as well be effected. How long can the family trust retain a logical, unimpugnable reason for existence?

Until the widow dies? Until all the children have left their parental home and moved into houses or apartments of their own? Until the widow has adjusted to the fact of dependence in the golden years and gone to live with one of her children? Until the incompetent who represents the main beneficiary of a trust dies? Until some other event occurs? Until an aged beneficiary dies?

Each case will have different considerations. The person setting up a testamentary trust will have his own situation and the situations of his beneficiaries in mind when he draws up the terms. These situations will affect his decisions.

Certainly, no formula can cover all the possible cases. One testator will have the trust continue until the youngest grandchild reaches the age of 21. Another will specify that a particular child must be of age and through school. Another will state that a son or daughter must have attained the age of 21. Others will specify that a beneficiary must be 25, 30, or even 35 years old.

A fact of life—and of trusts—must be recognized here: There is no ideal length of time during which a trust must remain in effect. The terms of a testamentary trust may make different provisions for different children of the same parents.

Shifting to the trustee the burden of deciding the duration of a trust may not solve the problem. The trustee may face the same difficult choices that the testator faced. For that reason, experienced trustees hesitate to accept trusts under which they have the power to terminate the trust when they believe it has served its purpose.

Using alternative forms of testamentary trusts, a testator can make ample provision for one or more beneficiaries for years into the future. The alternative forms are discussed in Chapter 8.

Chapter 5

FIVE VARIATIONS ON AN IV THEME

The inter vivos trust has come into its own in recent years in part because the flexibility of the living trust has convinced many people that it has immense—and growing—utility value.

That flexibility, among other factors, has caused a reshuffling of priorities among those who offer trusteeship services. It has become obvious that the trust can offer advantages to the middle-class client. Some statistics have been cited:

- In 1969, 3.3 million Americans had gross assets between \$60,000 and \$100,000.
- In 1972, that figure had increased by nearly 50 percent to 4.9 million.
- By 1977, the United States had approximately 18.5 million citizens with assets ranging from \$60,000 to \$200,000.
- Trust department customers (of banks and other institutions) comprise only .5 percent of the population. Yet those in the \$60,000–\$200,000 range make up approximately 10 percent of the American people.

Apparently, the middle-class client has reached a state of affluence that may well justify consideration of a trust. Trust services will continue to be standardized to an increasing degree, but individualization will still be necessary and possible. Typically, the standard living trust document offered by various banks concludes with a notation indicating that dispositive provisions of the trust agreement will appear in an addendum. The dispositive provisions give the trust instrument its individuality.

For instance, the J. Henry Schroder Bank and Trust Company of

New York offers such "package" trusts. Its Opportunity Trust format provides for individualization: None of the basic advantages of the living trust have been eliminated. The trust form only simplifies the process of setting up a trust. The trustor retains a broad range of dispositive options.

Details on the terms of five of the more basic living trust instrument formats follow. Such trust documents as these have made it possible for corporate trustees to serve middle-class clients more and more effectively.

FORMAT 1

Benefit of Trustor/Principal Afterward to Be Distributed as Directed

In format 1, Mary Howard found the perfect instrument for providing for the future of a crippled son and a healthy daughter as well as the infant child of her divorced sister. The trustee had discretionary power to use the trust income and, if necessary, portions of the principal for Mary's benefit during her lifetime. The trustee also had the right to terminate the trust at any time if he should decide that it had served its purpose or if the trust principal had dwindled to the point where continuance of the trust became inadvisable. Mary, a successful executive, also retained the right to amend or revoke the trust through presentation of a written document to the trustee.

Instead of placing Mary's trust property in her estate on her death, the trustee was instructed to keep the trust property separate from Mary's taxable estate. The trustee was obligated to pay to the estate any portion of the trust principal that was needed to pay claims against Mary or to cover her estate, funeral, and administrative expenses as well as estate and death taxes. But otherwise, the trust was to remain a distinct entity.

On Mary's death, the trust principal was to be distributed outright to the three children in equal shares. But the trustee had the discretionary power to decide at that time to use the income or principal as required for the support of "persons under 21 years of age or a person who in the Trustee's sole judgment is incapable of managing his own affairs." These payments could be made in any of four different ways:

- Directly to the parent, guardian, or other person caring for any beneficiary under 21 years of age “or to any authorized person as custodian for him under any applicable Gifts to Minors Act.”
- To the committee, conservator, or other person discharging the responsibility for caring for the incapacitated minor.
- Directly to the beneficiaries as allowances that the trustee might consider necessary.
- By expending the trust property in any other way, at the trustee’s discretion, so as to benefit the beneficiaries.

Such discretionary powers appeared to Mary to cover any contingency that might arise after her death insofar as the three children were concerned. The income from the trust—and the principal, if necessary—was to be used for her own benefit as long as she lived. Since the trust property, including landholdings, was valued at \$350,000, the income promised to be substantial. Mary’s two children lived with her; she had not remarried. Her trust estate would go to them and to her sister’s child after her death.

On termination of Mary’s trust estate, the trustee had the power to make payment in any of the four ways noted above to any beneficiary who might still be under 21. Alternatively, the trustee could defer distribution of the principal, or any part of it. If the decision was to defer, any beneficiary could continue to receive portions of both income and principal as the trustee saw fit. The trustee’s decisions regarding payments of income or principal could be made without consideration of the beneficiaries’ income or support from other sources. Such decisions could, and in all probability would, be made with definite reference to the beneficiaries’ ability to manage their own affairs.

FORMAT 2

Benefit of Trustor/Benefit of Trustor’s Spouse for Life/Principal to Remaining Estate

James Farrington selected a form of inter vivos trust that would provide for his wife in the event that he died before she did. The trust instrument did not, however, provide for division of James’s estate into A and B portions (as did the Doanes’s trust agreement in

Chapter 1). James Farrington did not feel that his \$135,000 estate warranted such division.

Like many Americans, Farrington's real estate—a small apartment building that Farrington owned—made up the bulk of his estate. He had bought the property in 1968 for \$34,000. When he made up the trust agreement in 1979, the building had increased in value to about \$98,000.

Farrington's lawyer had told him that starting in 1981 only estates valued at more than \$175,625 would be subject to federal taxation. Thus, Farrington did not have to protect his overall estate against federal taxation at the time of his death. This meant he did not need the divided widow's trust. He did, however, want to provide management aid and investment counsel for his wife. He also wanted to avoid the complexities and costs of probate. Although he had only about \$30,000 in life insurance, and a few thousand dollars in stock and bonds, he nonetheless thought that his wife could use help; he wanted her to serve as cotrustee, however.

The provisions of the trust agreement carried out Farrington's desires perfectly. The trustee had the power to use the income from the real estate and the stocks and bonds for Farrington's benefit while the trustor lived. In the event that it became necessary, the trustee could also use portions of the principal of the estate for the same purpose.

Farrington was thus taken care of for life—and without the headaches of real property management. He also made sure that his wife was taken care of.

On Farrington's death, the entire estate was to go to Farrington's wife, Joan, after payment of claims against Farrington or his estate. Joan would receive any income from the estate, which at that time would also include Farrington's life insurance. She would also be able to receive the principal, or portions of it, as required. The trustee could "apply to her use so much or all of the principal of the Trust as the Trustee in its discretion [might] deem advisable for any purpose whatsoever."

On Joan's death, Farrington's estate would go into Joan's estate. If Joan should predecease Farrington, the estate would remain in Farrington's name.

As is common, the trustee had the power to terminate the trust if

conditions should warrant such action. If termination should become advisable, on whatever ground, the trustee was bound to “pay out the principal to the person then entitled to income from the trust.” But the trustee had an alternative if the beneficiary at that point could not manage his or her own affairs: to turn the principal over to the committee or person “having the care and control of such incapable person (Beneficiary).”

The Farringtons had no children. Thus, they wanted to provide for the problems that advancing age might bring—including loss of interest in the care and management of property, loss of physical capacity, and other disabilities. But they ensured continuity in the application of funds from Farrington’s estate.

The trust solved their problems. As a precautionary measure Farrington retained the power to revoke or change the trust agreement, however.

FORMAT 3

Benefit of Trustor for Life/Benefit of Another Person for Life/Principal Distributed as Directed

Like formats 1 and 2, format 3 is a revocable trust arrangement. Using this format, John Thompson included the standard clause regarding income from the trust during the trustor’s lifetime. That clause provided that

net income from the trust [should be applied] to the Settlor’s use not more frequently than quarterly. The trustee may apply to the Settlor’s use so much or all of the principal of the Trust as the Trustee in its discretion may deem advisable for any purpose whatsoever.

Thompson had never married and thus had no direct heirs. But his brother Brent, 19 years younger, had a single son, Jason, who was 10 at the time Thompson created the trust. John Thompson wanted his \$240,000 estate to go to his brother as income beneficiary and to the son as remainderman. Should Brent have other children, they were to share equally with Jason as additional remaindermen.

John Thompson provided, thus, that he would have use of the income and, if necessary, parts of the principal as long as he lived. On his death, the net income from the estate was to be paid to his

brother as long as Brent should live. On Brent's death, the trust principal was to be distributed outright to Brent's children in equal shares.

A separate provision was included in the instrument to allow for the contingency that Jason might die before his father. In that case, if Brent had no other children, the estate was to go to John Thompson's two first cousins on his mother's side or to their five children in equal shares.

At the discretion of the trustee, the trust could be terminated when circumstances warranted. Equally important, when income or principal were to be used for the benefit of any beneficiary under the age of 21, or for a beneficiary who was incapacitated for any reason, the trustee had additional discretionary powers, paralleling those specified in trust format 1. By the same provision, the trustee could use his own judgment in paying out the principal to any person under 21 years of age at the time of termination of the trust.

This clause empowered the trustee to consider the condition and age of the principal beneficiary. The trustee could "make payment of principal in any of the four ways set forth . . . or it may defer payment of any part or all thereof." The trustee could then apply "to the use of such beneficiary so much or all of such principal and of the income therefrom as the trustee may in its discretion deem advisable."

Income that the trustee could not distribute was to be added to the estate principal, which was to be paid in full to the beneficiary when the latter reached 21. If the beneficiary died before such payment could be made, the principal was to be paid to that beneficiary's estate.

FORMAT 4

Benefit of Trustor/Principal Afterward to Estate

Some standard provisions made trust format 4 attractive to Edna Barlow, who had an estate of about \$210,000 when she decided to look into the possibility of a trust. An estate of that size, she had decided, deserved some special handling, especially since she and her husband had built it up by increments over a long period of time.

Edna, a widow, had three children whom she loved. She wanted the estate to pass to the children with as little tax loss as possible. She knew that, with assets over \$175,625, if she died after 1981 her estate would be subject to federal income taxation as well as state inheritance taxes and possibly other levies.

The living trust format that Edna chose provided for her as trustor for life; thereafter, the principal was to be distributed to her estate. The key provision read:

During the Settlor's lifetime, the Trustee shall apply the net income from the Trust to the Settlor's use not more frequently than quarterly. The Trustee may apply to the Settlor's use so much or all of the principal of the Trust as the Trustee in his discretion may deem advisable for any purpose whatsoever. Upon the Settlor's death, the Trustee shall distribute the Trust principal to the estate of the Settlor.

The trust agreement contained other provisions that Edna saw as necessary to carry out her plan. If Edna became incapable of managing her own affairs, the payments would be made to "the committee, conservator, or other person having the care and control of the Settlor." Also, because she wanted to divorce herself from management and investment responsibilities, Edna gave the trustee power to "invest and reinvest in property of any character, including participation in any one or more of the common trust funds maintained by the Trustee."

Because Edna's children were nearing their majorities when Edna established the trust, she decided to give the trustee the power to terminate the trust when that step seemed appropriate. Her children could and would be provided for, according to specific provisions of the instrument, until they had completed their educations. After that time the trust could be terminated, but the trustee would make that decision. The trustee could also "at any time in its discretion terminate this Trust if in its sole judgment the Trust is so small as to make it inadvisable to continue."

Wisely, Edna retained the right to revoke or change the trust at any time before her death, because she knew her family circumstances could change dramatically. She had close friends whose son and daughter had been killed in an auto accident; Edna had acquired a sense of the impermanence of life from watching the friends try to adjust after the accident.

The power to change the trust gave Edna the flexibility that she needed. The clause read:

The Settlor at any time during her lifetime by a written instrument delivered to the Trustee may amend or revoke this agreement provided that the duties and liabilities of the Trustee shall not be changed nor its compensation decreased except with its written consent. The Settlor may withdraw amounts of principal annually from the Trust only in the amount of \$1,000 or multiples thereof.

In the same provision, Edna surrendered the right to revoke the trust agreement by means of a will. She retained the right to increase the trust, or to allow it to be increased by others, "by delivering cash or other property to the Trustee, by having the proceeds of insurance policies paid to the Trustee, or by bequest by Will, all of which shall be acceptable to the Trustee."

Edna lived for six years after making out the trust agreement. In that time, she saw no reason to change the agreement in any way. It seemed to her—and proved in fact to be—an equitable and economical way to pass the estate to the children.

The estate actually grew substantially before Edna's death. The trustee, a bank, invested Edna's funds in high-yield stocks and bonds. For the most part, the corporate trustee ploughed the income from these securities back into the trust fund. Edna became dependent on others only after her arthritis forced her to stop working, a year before her death.

Edna's youngest son was in medical school when his mother died. The trustee decided to keep the trust alive until that son had finished his schooling. The plan met with the complete approval of the other two children, a son and a daughter.

All three children honored Edna's memory and respected her foresight.

FORMAT 5

Benefit of a Person Other than Trustor for Life/Principal Distributed Outright

Sam and Elaine Allison wanted to create an irrevocable trust. They had valid motives. They had amassed a small fortune, estimated at \$800,000, while operating a small drug manufacturing business. They wanted to retire and travel after selling the business or placing management in someone else's capable hands. They decided to create an irrevocable trust with \$300,000 and retain the rest. Trust format 5 proved appropriate for them.

The couple had two children, Frank and Margaret. The senior Allisons planned to provide for themselves during their lifetimes and then to leave their estate to their children in equal shares. They wrote that provision into their trust agreement, specifying that trust income and as much of the principal as might be needed were to be paid to husband Sam during his lifetime and to his wife throughout her life after Sam's death. That arrangement would continue until Sam's death. Afterward the trust principal would be turned over to the two children.

Note what the trust agreement achieved: It made Sam the income beneficiary for life and Elaine the successor beneficiary for her life. Most importantly, the agreement did what an outright gift could not do: It provided for lifetime beneficiaries as well as ultimate or remainder beneficiaries.

The trustee was instructed in the trust agreement to use the trust income for Sam's and Elaine's benefit during their lifetimes. The trust assets would be includable in the trustor's gross estate because he had retained the income interest—an "incident of ownership." If he had paid any gift taxes, there would be a credit for them against any estate taxes due.

More significantly, Elaine had been made a lifetime beneficiary only; at her death the assets would pass outright to the beneficiaries outside her estate. Thus, even though the \$500,000 gross estate might be included in Sam's estate, it would bypass Elaine's own estate and go outright to her children on her death.

A principal objective of an irrevocable living trust of this kind is to avoid having Sam's estate thrown back into Elaine's estate. For that reason, Elaine, who was a cotrustee with Sam during his lifetime, was not to remain a trustee after her husband's death. She was to resign in favor of another trustee or cotrustee. In this situation, she could receive the income from the trust estate and not run the risk that the trust property would be cast back into her estate.

CHOICE OF TERMS

A clause in an irrevocable trust would specify, "The trustor reserves no power to amend or revoke this agreement, but he reserves the right for himself or any other person to increase this trust by delivering cash or other property to the trustee, by having

STEPS THE ALLISONS COULD HAVE TAKEN TO MAKE SURE THAT ALL TAX CONSEQUENCES FELL ELSEWHERE

Sam and Elaine Allison could have made legally certain that all tax consequences of their creation of an irrevocable trust would fall elsewhere. To do so would not usually be necessary; their attorney could have guided them through the complexities of the irrevocable trust process. But to make doubly sure, they could have:

1. Reserved no trust income. The income would certainly be taxed to Sam and Elaine so long as they received it; also, under certain circumstances the trust property could be included in Elaine's estate.
 2. Reserved no other incidents of ownership in the trust property. Such incidents might include a contingent reversionary right under which the trust property could revert to Sam or Elaine if given conditions were fulfilled.
 3. Reserved no right to change beneficiaries or in any other way to change the terms under which the beneficiaries' interests become vested.
 4. Retained no power of management or administration over the trust assets. If the trustee was to administer and operate Sam's business, he should have that power without reservation.
 5. Made up their minds that they were giving property away—but in trust. The trust's provisions governing the rights and powers of the trustee would provide the only built-in control. Direct administration and supervision would be handed over to the trustee.
-

the proceeds of insurance policies made payable to the trustee, or by bequest by will, all of which shall be acceptable to the trustee."

The irrevocable trust instrument can be very simple. The key provision may read: "The trustee shall pay the net income derived from the trust estate to Sam and Elaine Allison as long as they shall live, and upon the death of one, thereafter to the other." In a second main provision, the following wording might be used: "Upon the death of the survivor(s) of Sam and Elaine Allison, the Trustee shall divide the Trust property into equal shares and forthwith distribute one such share each to Frank Allison and to Margaret Allison."

The trust agreement may contain numerous other provisions. For instance, Sam could have:

- Created a life income for Elaine *and* included a provision for invasion of the trust principal for Elaine's benefit.

- Provided for grandchildren in the event that any should be born to either Frank or Margaret.
- Written into the agreement provisions covering the contingency of the death of an ultimate beneficiary.

EFFECTIVE DATE

Typically, the irrevocable trust, like the revocable, becomes effective "upon execution by both the Settlor and the Trustee." The trust agreement then becomes subject to the laws of the state in which it has been made.

The trust instrument compares thus to a straightforward contractual agreement. But beyond the signatures of the trustor and the trustee, the agreement may carry the signatures of witnesses, or it may be notarized in case proof is ever needed that the instrument was legally executed. Neither formality is essential, however.

Chapter 6

CHARITABLE AND INSURANCE TRUSTS

Now that we have seen a few of the many different kinds of trusts, it has become clear that all trusts have some elements in common. It has become equally clear that trusts can be classified in many different ways, according to their purposes, the ways in which they are created, their revocability or irrevocability, and so on.

We have seen too that there are express or implied trusts and that the two major categories of trusts in general, practical use are the *inter vivos*, or living, and the testamentary trust. The active trust provides the trustee with specific powers and duties; the passive trust, in theory, assigns no such duties but specifies that the trustee can hold legal title to the trust property.

Obviously, trust formats overlap, at least to some extent. This comes about because trusts may be designed to accomplish a number of different purposes at the same time. Thus, a single trust document may contain features taken or adapted from a number of different types of trusts.

Trusts may even be used in combination. In some circumstances, an irrevocable trust may be combined with a revocable trust to produce an ideal package for a given client. This can occur, for example, where a trustor wants to retain the right to revoke a trust during his lifetime. The revocable trust then applies until his death. A companion trust, irrevocable according to its own terms, governs application of trust income and distribution of the trust estate *after* the trustor's death.

Two of the more common types of trusts that are distinguishable

by specific characteristics or provisions are discussed in this chapter. They are the charitable trust and the insurance trust.

CHARITABLE TRUSTS AND UNITRUSTS

In most of the cases summarized thus far, a trustor had more than one beneficiary in mind when the trust was created. As a trustor, however, you may face a problem: You may have *no* relative or friend whom you want to name as your beneficiary, or you may have only *one* such person. In this case, a charity may well become your immediate or ultimate beneficiary.

The circumstances may be readily imagined. Your bloodline may be dying out; you have not married and have no children or other close relatives. In many life situations, the potential or actual trustor may have limited personal ties or responsibilities to other living persons and perhaps none to persons not yet born.

In other cases, a trustor may have a more direct charitable motivation. For instance, he may feel strong loyalty to a particular eleemosynary organization. The charitable trust may have a variety of purposes, including the relief of poverty, even though the beneficiaries need not be destitute; the advancement of religion or of a particular religious cause; the advancement of public or private education; the promotion of health, including the maintenance of clinics and hospitals; the relief of the sick or insane; and assistance to government in the discharge of its public functions.

The charitable trust has become known as a public trust because it benefits, immediately or eventually, members of the public. All other trusts are known as private trusts. The charitable trust has to be created according to the norms, standards, and legal caveats established for trusts in general. If anything, the charitable trust is more complex than the private trust, and what constitutes a valid charitable trust represents an entire field of study.

In the briefest scope, those purposes already enumerated distinguish the valid trust. In addition, a trust may be set up for such purposes as the promotion of temperance, the relief of animals, and the improvement of government. A trust established to achieve political objectives, to build monuments to noted personages, and to benefit specific persons of limited qualifications or opportunities will probably not be recognized as a charitable trust. Nor will those created for the promotion of sports.

WHAT THE INTERNAL REVENUE CODE SAYS ABOUT DEDUCTIONS FOR INTER VIVOS CHARITABLE TRUSTS

The Internal Revenue Code specifies that the deduction of charitable trust estates will be allowed only for transfers to or for the use of:

1. The United States; any state, territory, or political subdivision thereof; or the District of Columbia, for exclusively public purposes.

2. Any corporation or association organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes (including the encouragement of art and the prevention of cruelty to children or animals), if no part of the net earnings of the corporation or association inures to the benefit of any private stockholder or individual (other than as a legitimate object of such purposes) and no substantial part of its activities is carrying on propaganda or otherwise attempting to influence legislation.

3. A trustee or trustees, or a fraternal society, order, or association operating under the lodge system, if the transferred property is to be used exclusively for religious, charitable, scientific, literary, or educational purposes (or for the prevention of cruelty to children or animals) and if no substantial part of the activities of such transferee is carrying on propaganda or otherwise attempting to influence legislation.

4. Any veterans' organization incorporated by act of Congress, or any of its departments, local chapters, or posts, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

TAX ADVANTAGES

The law smiles on the charitable trust, whether living or testamentary. Thus, this kind of trust has many tax advantages not granted to the private trust.

Almost without exception, U.S. courts apply liberal rules and interpretations to support charitable trusts. For example, the rule prohibiting creation of a trust in perpetuity does not apply, meaning that the charitable trust can be established to last "forever." The charitable trust also enjoys immunity from some of the rules on reversions of vesting interests as well as on suspensions of the power of transfer.

Whereas a private trust cannot exist without a named or ascertainable beneficiary, the charitable trust may have beneficiaries who are neither named nor ascertainable. In fact, a court could decide that a charitable trust is not actually charitable in nature if the beneficiaries are not indefinite. The same decision might occur if the beneficiaries are so limited in number that the community will not actually benefit.

In a specific case, a trust for the needy descendants of an individual trustor was held by a court to be private and not charitable in nature. In another case, a fund for scholarships to a named college was held to be charitable even though preference in awarding the scholarships was to be given to the trustor's descendants.

The public benefit derived from a charitable trust earns it its privileged tax status. No profit-making purposes can be involved. The creator of a living charitable trust can take an income tax deduction for the contribution—with some limitations. In the case of a testamentary trust, charitable bequests are deducted from the testator's gross estate. Partly because it brings tax advantages, a charitable trust is frequently created as a testamentary trust. There are other advantages as well, many of them intangible. Among these, the trustor with a large estate but little family may perpetuate his name and memory into the distant future.

CHARITABLE REMAINDER TRUSTS

In recent years, a combination public-private trust—the charitable remainder trust—has become popular. In this type of trust, the trustor usually specifies that the trust income will go to a private person for a specified period or for the duration of that person's life and, when that person dies, the remainder will go to a charity.

The income and estate tax laws dealing with the establishment and qualifications of charitable remainder trusts are complex and extraordinarily detailed. Careful study and usually the aid of an attorney are required if the trust agreement is to be drawn in such a way as to cover all the possible contingencies.

One such tax law provision can be noted. Guaranteed annuities or bequests specifying a fixed percentage distribution of income annually are the only charitable income interests that can be deducted. The fixed percentage distributions must be based on the trust property's fair market value determined yearly, and the distributions must be made annually.

Some difficulty faces the individual trying to determine the amount of a charitable deduction where a charitable remainder trust has been created. The tax laws in this area show great complexity. Generally, no deduction will be allowed for a charitable remainder unless one of three specific formats is used:

1. *The charitable remainder unitrust.* In this trust, the distributions

SOME PRECEDENTS ON EARMARKED CHARITABLE GIFTS

You may want to look twice at that gift of money you are about to send off for a favored cause. The following cases—with names and minor details changed—suggest why.

The parents of traveling evangelist Earl Browning sent \$2,400 directly to the owner of the seven-room home in which their son lived when he was staying in San Francisco. Founder and president of Greater Freedom Gospel Church, Inc., a tax-exempt religious organization, Earl officially lived with his family. Earl's parents claimed the \$2,400 as a charitable deduction because it had been made "for the use of" the religious organization.

The tax court denied the deduction, noting that it did not meet the tests for deductibility. In particular, as a payment not made directly to a charity it was not earmarked "for the use of" the charity in a manner similar to that indicated by the phrase "in trust for."

John and Millie Glanz wrote a \$1,000 check payable to their bank. The check bore the notation, "for Bank check, Bap. missions." Without identifying the donors, the bank was enjoined to send its own check to Reverend Malcolm Jamieson, at that time active in Baptist missions in the Southwest, to aid in his mission work. The Glanzes claimed the \$1,000 deduction. Naturally, they said it was for "Baptist missions."

After much deliberation, the IRS allowed the deduction. The check had been made payable to the Reverend Jamieson, and it had been mailed directly to him. Yet it did not constitute a gift to him personally, the IRS said, because the bank had been instructed to tell the reverend that the funds were to be used to forward the mission work.

Student Robert "Bob" Crown has obtained, as a result of his own solicitation, contributions to his school from two retired couples. Bob attends a religious college, taking a four-year work-study program that includes courses in liberal arts, the humanities, and Bible studies. The contributions go directly to the college, but the donors name the student—in this case Bob—who has obtained the sponsorship.

The IRS denied the couples' deduction claims. Despite the lack of specific earmarking, the IRS said, and in spite of the fact that the contributions went directly to the school, they represented gifts for one person and no other.

Mark Gellner, a wealthy manufacturer, wanted to help one of his top employees get a college education. Joe Langsdorf, the employee, told Gellner what college he wanted to attend. Gellner wrote to the college, asking whether in the college's opinion a \$10,000 donation could be applied to Joe's education even though in most cases the recipient of such gifts remained unspecified. The college, accepting the check, wrote back to say that the donation had been credited to Joe's account.

Perhaps expectably, the tax court disallowed Gellner's deduction claim. The donation could not be viewed as a charitable deduction, the court ruled, because the funds had been unequivocally earmarked for one recipient.

from the trust estate fluctuate. They are determined as a fixed percentage of the annually calculated value of the trust estate. The percentage cannot be less than 5 percent. Payments must be made at least annually to one or more noncharitable income beneficiaries. The remainder is eventually transferred to a charity.

2. The *charitable remainder annuity trust*. Unlike the unitrust, the annuity trust pays out a specific sum at least annually. These funds must go to one or more beneficiaries for life or for a period not to exceed 20 years. The remainder is transferred at the end of the period to a charity. The percentage of the trust estate that may be paid out cannot be less than 5 percent of the value of the property when it was placed in trust.

3. The *pooled income fund*. In this form of the charitable remainder trust, the trust consists exclusively of irrevocable remainder interests that have been contributed to the charity maintaining the fund. When the trustor dies, a life income interest in the trust property goes, under the terms of the trust agreement, to one or more living beneficiaries for life. The trustee makes payments out of the trust fund to each beneficiary at a rate determined by the fund's rate of return.

The pooled income fund has some other unique characteristics. Its income must be distributed currently; payments must be made within 65 days after the close of the tax year in which the income was earned. The present value of the charitable remainder interest—the estate that will go to the charity after the beneficiaries have died—determines the amount of the charitable deduction; that entire amount may be deducted from the trustor's estate in any given year.

A rather complex formula is used to determine the present value of the charitable remainder. This value is held to be the present fair market value of the assets transferred to the noncharitable beneficiaries, less the life income interest of these beneficiaries.

THE UNITRUST

The unitrust has become a preferred method of giving to charities for a variety of reasons. Thus, it deserves special description and analysis.

In particular, the unitrust derives importance from the fact that it involves fluctuating distributions, based on the annually determined value of the trust property. This factor alone has been said

to be the cause of a change in the investment philosophies of trustees. Several reasons have been cited.

Formerly, trustees felt obligated to make trust income payments to one or more noncharitable beneficiaries. They had, they might well have believed, to invest so as to produce a reasonable return for the income beneficiary. The unitrust removed that pressure. It substituted for the established-in-advance annuity payments the distributions measured by the annually determined value of the trust assets. Because total return reflects all the income from dividends, rents, interest, and so on, as well as gains from appreciation in value of stocks, real property, and other assets, the trustee's job was simplified. The trustee could invest for total return and did not have to strive to ensure a minimum of 5 or 6 percent of trust income every year.

The growth of the trust corpus was virtually guaranteed by the change in philosophy. In this situation, too, the remainderman—the charity—would remain intensely interested in the growth of the trust estate. Essentially, both the life interest beneficiary and the remainderman would benefit.

The trust instrument will normally provide that income distributions under the unitrust be made at the rate of 6.0–6.5 percent. Higher rates may also be specified, but rarely lower rates. In those situations where the payments of income run less than the required percentage under the trust agreement, the instrument may specify that the income payments be made nonetheless. A condition may be attached: The trust instrument must also provide that the deficit for any given year be made up out of any excess of trust income over the required percent in subsequent years.

THE CY PRES RULE

The cy pres rule or doctrine can be applied only where charitable trusts are concerned. Essentially, the rule holds that a court may modify a charitable trust to meet changed conditions—that the court may, in fact, order application of the trust property in a manner similar to that specified by the trustor. In a private trust that fails for any reason, the trust property will ordinarily be returned to the estate of the trustor or to the trustor's heirs, and the trust will then be terminated. A court will not normally try to reconstruct the private trust for new, different, and legal purposes.

Where a charitable trust is involved, a court will attempt to serve

the public interest. That means it will try to keep the charitable trust alive if the trust agreement shows clearly that the trustor wanted to contribute to a charity. The trust may have failed for a variety of reasons. For example, the trust may have proved to have an illegal purpose or the trust document may have failed to specify any purpose at all.

Numerous legal cases point to the tendency among equity courts to try to save the charitable trust. Courts have made that kind of effort even where the trustor's specific purpose remains largely unexplained. In a landmark case, a trustee was directed to select, at his own discretion, the charitable beneficiary. The trustee died before the choice could be made. The court devised a *cy pres* plan for the use of the trust property.¹

The case known as *Harvard College v. Attorney General* contains another precedent for application of the *cy pres* doctrine.² In this case, a wealthy testator had retained a lifelong interest in both the science of engineering and in Harvard College. On his death, he left a large trust fund for the construction of a school of engineering at Harvard.

By mutual agreement, the governing officers of Harvard and of the Massachusetts Institute of Technology developed a plan under which the trust property was to be applied in a slightly different way from that specified by the trustor. The plan called for use of the trust fund to expand the superior engineering school at MIT. Compensatorily, students at MIT would be allowed to use the Harvard facilities for liberal arts education.

The court found that the trust fund might be used with greater effectiveness by MIT. The petition was nonetheless denied on the ground that no real reason had been advanced why an engineering school should or could not be built at Harvard.

INSURANCE TRUSTS

The insurance trust may take various forms. In one case, income-producing property may be transferred to a trust that will

¹*Minot v. Baker*, 147 Mass. 348, 17 N.E. 839 (1888).

²*The President and Fellows of Harvard College v. Attorney General*, 228 Mass. 396, 117 N.E. 903 (1917).

be responsible for paying the insurance premiums on the life of the son of the property owner. The income will be taxed at lower rates than if the son were paying the premiums. Also, more insurance can be carried than the same property would support if it were presented outright to the son as a gift. More importantly, perhaps, from a tax viewpoint, both the income and the insurance proceeds can be kept out of the estates of the son and his wife.

In the more common case, life insurance proceeds, to be paid at some time in the future, comprise part or all of a younger person's estate. The policies may have been taken out and paid for by the individual, or they may have been company sponsored. In some cases, especially where companies are providing for the families of professionals or executives, the proceeds may reach well up into the six-figure category.

The life insurance policy is considered property. For that reason it can be, and usually is, made the subject matter of a living trust. The terms of the trust specify that the trust itself will be the beneficiary rather than any individual. Where it has no other assets, the trust simply lies dormant until the insured dies. No management responsibilities exist. Where the trust has other assets, the trustee is of course required to fulfill his obligations to the trust and the beneficiary to the best of his ability.

The insurance trust can be revocable or irrevocable. In the former case, the trustor—the insured—retains all rights to change or revoke the trust agreement. The trustor also retains all rights to the life insurance policies and can even borrow on them or cancel them.

The proceeds of insurance policies will usually go into the insured's estate, but they do not necessarily do so. If a wife owns a policy on her husband's life, and has paid the premiums, the proceeds of that policy will not go into the husband's estate.

The holder of substantial life insurance may have a number of different reasons for establishing an insurance trust, and these will dictate the kind of trust the policyholder creates. There are a number of options. First of all, a policyholder might create a living trust that includes as part or all of the trust property the life insurance contracts under which the policyholder has coverage. The trust would also include the insurance proceeds after the death of the insured.

Under another option, the insured could make the insurance payable to his own estate and then provide by will that the proceeds are to be held in trust. In this case, the trust would classify as a testamentary trust.

What would you do if you owned your own business and were covered by life insurance policies that would pay your family a total of \$350,000 after your death? You might select a personal insurance trust or a business trust. Under each of these, you would have several other choices to make.

PERSONAL INSURANCE TRUSTS

Most simply, no business interest is involved in the personal insurance trust. That negative definition means that these trusts are created by individuals for other individuals. They may also be created for institutions or other groups capable of becoming beneficiaries—that is, of owning property.

In the most straightforward case, John Jones, the insured, creates a trust under which his life insurance proceeds will be paid to James Brown, the trustee, for the benefit of Mary, John's wife. But there are at least three subcategories of personal insurance trusts: the funded, the unfunded, and the installment insurance trust.

1. *The funded insurance trust.* In this kind of personal insurance trust, the trustee has funds out of which he pays the insurance premiums. Alternatively, he has property that provides income to cover the premiums. The trustee has the obligation, under the trust terms, to pay these premiums as long as funds or assets that make such payments possible exist.

John Jones, in the case already noted, might have set aside \$150,000 in securities. To pay the premiums on an equivalent amount of insurance, he gives his trustee the power to pay the premiums either from the income—dividends or other income—or from the principal of the \$150,000 in securities.

Jones could, of course, have placed the securities in trust and then continued to pay the premiums himself. But if he had done so, he would not have established a funded insurance trust, because the trustee would have had no duties with regard to the premiums. He would only have had the funds that might have been used for that purpose.

2. *The unfunded insurance trust.* The unfunded insurance trust has, in effect, just been described: The trustee has no obligation to pay the premiums on the trust insurance. Usually, the trustor—the insured—pays the premiums and keeps the insurance in force, but the trustor in many cases insures the life of another person and carries the premium payments.

3. *The installment insurance trust.* This kind of trust has also been called an accumulating, or cumulative, insurance trust. It has been so named because it accumulates periodic installment additions to the trust fund. The trustee has the responsibility for paying the premiums so long as he has funds or property to cover the payments. This trust converts very often to a funded insurance trust. Thus, it has been found to be adaptable to the needs of a young person who is in the process of building an estate.

Jones could have chosen to establish an installment insurance trust. He might, for example, have placed in trust \$100,000 in life insurance. The premiums amount to \$3,000 annually. Jones would need \$50,000 in securities paying 6 percent a year to produce enough income to cover the premiums.

Jones now faces a problem. He has only \$25,000 in securities. So he establishes an installment insurance trust. He puts both the \$100,000 in insurance and his \$25,000 in securities in trust. At the same time, he commits himself to add \$150 in cash to the trust account per month—\$1,800 per year. The \$1,800 is used to cover the difference between the income from the securities at 6 percent, which comes to \$1,500, and the total \$3,000 owed annually on the insurance. Jones would be paying his premiums and accumulating \$300 a year in the trust over and above its original assets.

BUSINESS INSURANCE TRUSTS

I will discuss these only briefly, because they do not fall in the category of personal trusts, the subject of this book. Business insurance trusts include five basic types:

1. *Key-man insurance trusts.* These are established by a business for its own benefit. A proprietorship, a partnership, or a corporation creates the trust by purchasing insurance on one or more of its key people and then puts the insurance in trust. The business either pays the insurance premiums itself or places in trust enough property to cover the premiums. The trust agreement specifies

what is to be done with the insurance proceeds in the event that the insured die.

2. *Insurance trusts for liquidation.* These are established to ease the process of liquidating a business or business interest. The trust makes it possible for the business owner to cash in on his interest in the enterprise. The owner, in brief, takes his interest out of the business, in the form of a proprietorship, partnership, or stock-purchase arrangement, and places it in trust to keep the business in operation after his death.

3. *Proprietorship insurance trust.* In this type of trust, the proprietor of a successful business insures his own life. The business pays the premiums. On the proprietor's death, the insurance proceeds, or part of them, go to a trustee; the trustee buys an individual in the firm, named by the proprietor, a share in the business to ensure its continued existence.

4. *Partnership insurance trusts.* These are used to protect the partners in a business. If the business has an overall worth of \$200,000, the two partners might insure each other's life for \$100,000, setting up a trust and providing that on the death of one insured the proceeds from his policy be used to purchase the decedent's interest for the survivor.

5. *Stock-purchase insurance trust.* These can be used by the shareholders of a closely held corporation to provide the same protection that the partnership trust provides. Typically, the three or so shareholders in the corporation would each insure the lives of the other shareholders. Each names the same trustee, specifying that the trustee is to use the insurance proceeds when a shareholder dies to purchase the decedent's stock for the accounts of the two survivors.

PURPOSES OF INSURANCE TRUSTS

In general, four purposes can be served by personal insurance trusts. These widely accepted goals do not by any means exhaust the possibilities, but they do indicate some of the situations in which this kind of personal trust has utility value.

1. *To unify the insured person's estate.* "To unify" in this context means to bring all the different insurance policies held by one person, usually with various companies, under a single plan of administration and distribution. Unification may be especially de-

sirable where the insured depends largely on his insurance to provide for his family.

The unification process may have other important aspects. The trust may become the guarantee of security for an insured's general estate as well as his insurance estate. This may occur where an executor under a will and a trustee under a trust agreement have matching powers to make sales to or obtain loans from one another. The estate as a whole may be protected and preserved in the interests of the beneficiaries simply because sacrifice sales are rendered less likely in a time of need and turmoil.

2. *To provide a trusted advisor on the scene.* The relationship between an insured and his or her beneficiary ordinarily involves a sense of obligation on the part of the insured and a feeling of reliance or dependency on the part of the beneficiary. When death terminates that relationship, the beneficiary may feel lost. He or she may urgently need a local advisor who can step into the shoes of the decedent to give assistance and counsel as needed.

The trustee may well be the only person who can discharge that role. A widow may not want to bring other members of her family into her affairs, or she may simply have no one to whom she can go for advice. An insurance company cannot furnish an advisor, though an insurance representative can often give assistance on insurance matters. In most instances, the insurance company will have its home offices in a city distant from that in which the insured and his family live. That circumstance alone may make it impossible for the widow to receive help or counsel from that quarter.

The trustee, usually a local bank or trust company, can logically step into the role of personal advisor. The professional corporate trustee, in fact, has that role in the forefront of its responsibilities vis-à-vis beneficiaries. Rendering personal aid and giving expert advice fall naturally within its purview.

3. *To ensure flexibility of administration.* It has already been noted that the trust as a legal device offers immense flexibility as regards the trust instrument and its specific provisions. That flexibility can be written into the agreement; the trustor makes certain, with the wording of the trust terms, to give the trustee adequate leeway.

In allowing for flexibility of administration and discretionary judgment in the application of insurance proceeds, the insurance

trust may be an irreplaceable tool. Where the insured has left a family, the insurance may have to be applied for the support and maintenance of the family members. Where children are involved, continuing educational needs can be expected. Other requirements of a financial nature will usually appear. Many of these will come without warning; the decedent could not possibly have foreseen them.

Flexibility in the management of an insurance trust can actually guarantee that the basic purposes of the trust will be achieved. The trustee may have to exercise his authority and change the method of handling the trust estate—for example, in the case of a beneficiary who becomes dependent or incompetent after years of completely normal functioning. The trustee's judgment would govern the application of trust funds both earlier, when the beneficiary needed no help, and later, when help became crucial to the beneficiary's maintenance of dignity and comfort.

Discretion, of course, has many facets. In granting a trustee discretionary powers, an insured is creating a legal entity he hopes will act as he would have. Over a period of time, in the conscientious exercise of his powers, a trustee may see that the funds he is paying out for the support of a widow have become inadequate. The trustee may have no control over the inflation that has caused the buying power of the widow's stipends to shrink, but if he has discretionary powers, he can make up for the shrinkage by applying portions of the principal as well as the income or interest for the widow's benefit. If the trustee had the authority to invest the insurance proceeds for growth rather than for income, the trust fund could well have increased in value at a rate equaling or surpassing the rate of inflation.

Only a trust can provide the flexibility that makes it possible to adapt an estate to any financially manageable need. The decedent cannot be present to make certain that his wishes are fulfilled, and the insurance company has neither the responsibility for nor the capability of providing advice, counsel, and actual assistance. The insurance company has discharged its obligations when it has paid off on the insurance contract, but where an insurance trust has been established, the trustee remains.

Given adequate authority with flexibility, the trustee can supplement the beneficiary's own wisdom. The trustee will ordinarily

respond to the beneficiary's sense of need if the purposes of the trust and the powers of the trustee are spelled out accurately. That is, after all, the trustee's function: to make certain that the trustor's goals are achieved.

As a precautionary measure, the beneficiary can be made a cotrustee. In this role the beneficiary has coresponsibility and coauthority in the implementation of the insurance trust agreement.

4. *To prevent estate shrinkage.* This final key purpose of the personal insurance trust reflects another advantage of trusts in general. Where insurance proceeds go directly into a decedent's estate, those funds become subject to all the charges against the estate. The funds may not be used to the best advantage in defraying the various charges and costs.

Under an insurance trust arrangement, the insurance proceeds are paid into a trust whose terms may include specific instructions on many subjects. The insured may, for example, speak from experience in detailing ways to avoid or prevent shrinkage of the estate as a result of debts, taxes, and expenses. The proceeds of the insurance can then be applied to pay obligations and support or maintain the beneficiaries with the least possible sacrifice of the estate's general assets and with the least possible shrinkage of the trust corpus.

DISTINCTIVE CHARACTERISTICS OF INSURANCE TRUSTS

Insurance trusts have distinctive features that set them apart from other kinds of trusts. For the most part, these are technical aspects that relate to the insurance policy and the nature of the trust agreement. The main distinguishing characteristics are discussed briefly below.

Insurance payments are made payable to the trustee (1) by designation or change of beneficiary in the insurance policy or (2) by assignment. In a revocable insurance trust the insured would most appropriately have the insurance paid directly to the trustee or would make the trustee the beneficiary of the policy instead of a person or persons named earlier. The insured retains the right to make such changes at any time. Thus, he could, if desired for any reason, name a new trustee.

The assignment process requires that the insured assign to his

trustee all right, title, and interest in and to the insurance proceeds. From that point on the insurance becomes payable to the trustee. The assignment generally has an element of finality. Thus, it is used where irrevocable trusts are involved.³

To avoid confusion and possible litigation, the trust agreement and the insurance contract should specify in identical terms the method by which the insurance funds are to be paid to the trustee. With irrevocable trusts in particular, problems may arise if the trust agreement states that the policy has been assigned to a particular trustee and the insurance contract indicates that a change of trustee has been made, with a new trustee's name inserted.

In personal insurance contracts, the insured reserves certain rights, usually including the rights to obtain advances or loans; to receive and apply dividends or surplus shares; to sell, assign, or pledge the policy; and to change the beneficiary. In an irrevocable insurance trust, the trustor/insured should include a clear specification of the rights he wants to retain. Thus, no question can be broached later by the trustee, the insurance company, or the beneficiary regarding the reserved rights.

Where an unfunded trust is created, the trust agreement should specify that the trustee has no obligation to pay the insurance premiums. In the case of a funded trust, a number of provisions should be included. These would state whether the trustee can invade the trust principal to pay premiums if the income is insufficient; whether the trustee can float loans with the insurance to keep a policy in force if both principal and interest are exhausted; and whether the trustee has to notify the beneficiary or the insured if all cash assets have been exhausted. In the latter situation, the insured or the beneficiary might provide new funds to keep the policy alive.

Other provisions should also be explicit. The trust agreement should spell out the method the trustee should employ to terminate responsibilities with regard to the trust in the event that all funds are exhausted. If the trustee is required to advance money to keep insurance in force, the method by which such funds are to be recovered should be noted.

Whether an insurance trust is funded or unfunded, the trustee

³A designation refers to simply designating the trustee as beneficiary of the policy. An assignment refers to assigning all rights of ownership in the policy to the trustee.

has the right and duty to collect the insurance proceeds when a policy matures. The trustee's rights in this regard are, in fact, the same as those of any insurance beneficiary. Where a trust has been funded, the trustee will normally have cash or other assets with which to enforce collection.

In cases where an insurance company denies its liability under a policy, the trustee may be called on to take some kind of legal or other action. Unless the trust agreement has stated clearly what the trustee's prerogatives and duties are, confusion may reign. The trustee may not know whether to seek a legal remedy or to make an effort to compromise with the insurance company.

In line with the practices of most insurance companies, trustee-beneficiaries today have the same settlement options as any other beneficiary. The trust agreement should nonetheless make such a right explicit. Only in this way can the trustor make his wishes clear.

The options open to an insured suggest how confusion could arise. The insured may want the trustee to collect and administer the insurance proceeds strictly for the purposes noted in the trust agreement, or the insured may want to give the trustee the discretionary power to leave the insurance funds with the insurance company. The trust agreement should be drafted in such a way as to dispel doubt on this question. The insurance company is today relieved of any responsibility for administering insurance proceeds placed in trust. A specific provision to that effect is ordinarily included in the trust agreement.

The trustee may, by the terms of the insurance trust, be authorized to use the insurance proceeds to buy an annuity for the trust beneficiary. The power may, again, be discretionary. The trustee would have authorization to invest the trust funds if he decides that it is in the best interest of the beneficiary to do so.

The question of whether a trustee should or should not purchase an annuity may fundamentally affect the future of the trust. If the trustee invests the insurance proceeds in this way, his responsibility for administering the trust may end.

METHODS OF SETTLEMENT

The insurance trust has been called an additional method of settlement under a life insurance policy. Actually, the insured has the same basic insurance payment options: lump sum and op-

SOME KEY PROVISIONS OF A FUNDED REVOCABLE INSURANCE TRUST

Special provisions set the funded revocable insurance trust apart from other trust forms. These provisions, for example, state that the insured has taken out a life insurance policy, or more than one, that these are to be paid to the trustee on the insured's death, and that other property has been delivered to the trustee to fund the trust. Although they don't comprise a model trust form, the following typical provisions may appear in the funded revocable insurance trust agreement, usually in far more detailed form.

Item I. The insured has caused certain policies of life insurance to be issued on his life, as set forth in Schedule A attached hereto as part of this agreement. The proceeds of these policies now are or hereafter will be made payable to the Trustee either upon the death of the insured or upon the occurrence of some event before or after his death. . . .

The insured has also delivered to the trustee certain property itemized on Schedule B attached hereto as a part of this agreement. This property, together with other property which hereafter may be brought within the operation of this trust, and the life insurance policies mentioned above, shall constitute the trust estate. . . .

Item II. Out of the net income of the trust estate and out of the principal to the extent to which it may be necessary, the trustee shall pay the premiums and assessments and other charges on the above-described policies and additions thereto as they fall due. . . . Any surplus income shall be added to and be reinvested as a part of the trust estate. . . .

Item III. During his lifetime all rights of every nature accruing to the insured hereby are reserved by him, to be exercised in accordance with the terms of the respective policies. . . .

Item IV. As soon as practicable after the death of the insured, the trustee shall make proofs of death and shall collect all monies due under the policies then within the operation of this agreement and then payable to the trustee. Likewise, as soon as practicable after the occurrence of any event before or after the death of the insured which may cause any policy or policies then within the operation of this agreement to become payable to the trustee, the trustee shall make proper proofs and shall collect all monies then due under such policy or policies. . . .

Item V. The insurance company or companies, issuing any of the policies which are made a part of this trust, or may hereafter be made a part of this trust, shall not be held or bound in any manner or to any extent or be responsible for the application by the trustee of the insurance money payable hereunder and paid to the trustee. . . .

Item VI. If any company issuing a policy or policies now or hereafter brought under the terms of this agreement will hold the proceeds of such policy or policies under any of the options of settlement contained in such policy or policies, the trustee may . . . allow the said proceeds accordingly to remain with such insurance company under any of the available options of settlement. . . .

tional. But the trust adds flexibility. The trust provisions could, for example, call for special allocations of the insurance proceeds under given circumstances.

The various techniques of settlement have distinguishing characteristics. In the lump-sum settlement, as the name implies, the insured specifies that the insurance is to be paid in a lump sum to a named beneficiary. That beneficiary may be a spouse, an estate, a child, a business associate, or anyone else who can own property. The lump-sum form of settlement is very commonly used.

In the optional mode of settlement, the insured chooses one of the options offered by the insurance company. These options vary widely from company to company and policy to policy, but they are generally classified as interest, installment, and annuity options. In the first of these, the insurance company retains the insurance proceeds and pays out interest at regular intervals at a minimum specified rate. This procedure continues until the principal has been withdrawn or completely paid out.

If the insured selects the installment option, the insurance company again retains the proceeds but makes payments of interest and principal combined. The size of each payment is determined by the number of years over which disbursements are to be made or by the amount fixed in advance for each payment regardless of the number of years required to exhaust the fund.

Under the annuity option, the insurance company again retains the insurance proceeds but pays the insurance in installments for the remainder of the beneficiary's life. The terms of the insurance contract may provide that payments will be continued, even if the beneficiary dies before all payments have been made, until a stated number of annuities have been disbursed.

The insured has the choice, finally, of the insurance trust. Under this arrangement, the insurance proceeds go to the trustee. Normally the insured will indicate the purposes he wants to accomplish with the insurance money.

Aside from tax questions, you should consider at least two factors when you are examining modes of settlement of insurance proceeds. You may want, first, to ascertain whether you can engage the services of a competent trustee. Second, you will undoubtedly want to consider whether the immense flexibility of the insurance trust gives your beneficiaries an added measure of protection that they might need after you have died.

The questions that you should ask relate to your situation and that of your family: Is there a beneficiary, potential or actual, who may need special attention or assistance after your death? Is your chief beneficiary capable of owning, managing, and perhaps investing the proceeds of your insurance policies? Or should you bring a trustee into the picture as an advisor and confidant?

How you answer the questions may determine the effectiveness with which you provide for your family or other beneficiaries. If any single argument points to the utility value of the insurance trust, it would undoubtedly be this: that the "scares and alarums" that invade every life can best be accounted for in advance by establishing an insurance trust.

Chapter 7

SHORT-TERM TRUSTS

The short-term trust—also called a Clifford or revisionary trust—always has a specific purpose, and this must relate to a beneficiary. But perhaps more than anything else the short-term trust constitutes a tax shelter. A simple principle undergirds the short-term trust: A taxpayer or trustor can make a temporary gift of property, placing it in trust in such a way as to ensure that, until the trustor gets the property back, the income from it will be payable and taxable to someone else.

Exhibit 2 shows a sample short-term trust synopsis form. The form not only summarizes basic information on the short-term trust but also serves as a handy reference during the trust's lifetime.

How the personal and financial motivations combine in the short-term trust may be illustrated by another mini-case history. In this instance, Stewart Ballangee placed \$200,000 worth of stock in trust for his mother, who was 65 years old. The stock produced a modest 4 percent yield annually, or a yearly income of \$8,000.

Let's assume that Stewart's mother has a life expectancy of 11 additional years. Stewart could obviously give his mother the income from the stock each year without creating a trust, but because he is in the 60 percent tax bracket, he would pay \$4,800 in taxes annually on that income. That would leave \$3,200 for his mother. Over 11 years, Stewart would pay \$52,800 in income taxes, and his mother would receive \$35,200 for living expenses.

Under the short-term trust, Stewart's mother receives the \$8,000 as income each year. Since she has double exemptions—the dividend exclusion and the standard deduction—she pays only \$418

Exhibit 2. Sample short-term trust synopsis form.

Name of Account	No.
Date of Trust	
Cotrustee(s)	
Consultant(s)	
Attorney	
Beneficiary(s)	Age
Powers over Income	
Accumulated Income	
Distribution during trust	
Distribution at termination	
Investment Powers	
Market Value at Inception of Trust	
Composition	
Bonds	\$
Stocks	\$
Mortgages	\$
Notes	\$
Real Estate	\$
Cash	\$
Miscellaneous	\$
Total	\$
Termination	
Basis for Income Tax	
In general file	
In investment file	
In tax file	
Gift Tax Return	
Prepared by	
Filed (date)	
Remarks	

Source: E. William Carr, *Short-Term Trusts* (Englewood Cliffs, N.J.: Prentice-Hall, 1973), p. 166.

a year in income taxes and has the remaining \$7,582 available for her personal needs. Over 11 years, she would pay \$4,598 in taxes; the money left over for her to spend would total \$83,402. Thus, Uncle Sam would receive \$48,202 less in income taxes over the 11-year period than if Stewart were paying the tax.

Stewart has used up some estate tax privileges in establishing the trust, and his unified credit is also affected, but the huge tax savings in favor of his mother far outweigh the minor penalties Stewart faces for placing part of his property in trust.

CREATING THE SHORT-TERM TRUST

As is the case with other trusts, the short-term trust must be structured and administered so that the trustor will not be taxed on its ordinary income as long as the trust remains in effect. That means the trustor cannot retain any significant incidents of ownership. With short-term trusts that problem has special difficulties because the trustor retains the right to recover the trust assets when the trust is terminated.

ADVANTAGEOUS USES

It has been noted that all trusts should have valid reasons for existence aside from their tax aspects. Some of the purposes for which short-term trusts are commonly created include:

- Accumulation of a fund for minor children.
- Assistance to grandchildren for special or general purposes.
- Assistance to adult children to purchase a home, to complete professional education, or to supplement income.
- Purchase of life insurance on one or more beneficiaries.
- Assistance to needy, incompetent, or aged relatives.

Many other such goals could be listed. Whatever the special purpose, the trustor has to follow some clear-cut rules to derive benefit from the trust. He must note and heed the limitations on his own control of the trust but within the terms of the trust can retain rather extensive powers over the trust's beneficial use. The trustor can even retain some authority over its administration.

The trustor cannot, however, retain the right to revoke the trust

before the expiration of ten years. Nor can the trust income inure to the benefit of the trustor or his spouse. Very importantly, the term of the trust must run at least the specified ten years; for that reason, the short-term trust has been called the “ten-years-and-a-day” trust. Alternatively, the duration of the trust and reversion to the trustor of the trust assets must be hinged on the death of the income beneficiary or beneficiaries. Where reversion of the assets is contingent on the death of a beneficiary, the trustor will not be taxed on the trust income even though the beneficiary could not reasonably have been expected to live ten years.

For these and other reasons, the short-term trust requires careful study. It has in recent years become more useful as a device for assisting the aged than as a means of helping a young person. This is in large part because of the tax breaks accorded the elderly, like Stewart Ballangee’s mother.

THE PROPERTY

Not every kind of income-producing property may be utilized to create a short-term trust. But the acceptable property types include nearly all those that can be placed in any trust. Among them are rental real estate; stocks and bonds, including stocks that confer control of a corporation (control stocks); borrowed funds; shares in a mutual fund; and a family partnership. Some caveats attach to this list. For example, real property that is rented to the trustor cannot qualify as corpus of a short-term trust.

What forms of property are unacceptable? In general, copyrights and patents are not considered suitable, because they do not meet the requirement that the trust produce a steady income. Also, the corpus must in the ordinary course of events revert to the trustor. Insofar as copyrights and patents are concerned, two points may be made:

1. Copyrights and patents produce royalty income that is not subject to a percentage depletion deduction, but the taxpayer can recover the cost or other basis during the life of the property.
2. It may prove difficult to calculate the gift tax value of copyrights and patents.

Obviously, a copyright or patent that is transferred into a short-

term trust will deliver, at best, an uncertain income. Secondly, when it eventually reverts to the trustor, the corpus will have less value than when it was placed in trust.

Courts have also found objectionable the practice of including a capital gain, or a gain that might arise after the trust has come into being, in the value ascribed to the property of a short-term trust. Because of adverse decisions in these cases, trustors generally make no provision for the distribution of capital gains under a short-term trust. The trustor may have to pay taxes on these gains, but the value of the trust is not materially undermined.

THE TRUST TERMS

The terms of a short-term trust present the trustor with major challenges, as noted. These challenges center largely on the ways in which the trust instrument should set out and describe the powers that affect the beneficial enjoyment of the trust income.

In general, these types of powers fall into three subgroups:

- The powers that the grantor or anyone else (such as the trustor's lawyer or brother) may retain.
- The powers that trustees—excluding the trustor and the spouse living with the trustor—can retain.
- The powers that can be assigned to independent trustees. (All trustees are independent when none of them is the grantor and no more than half are related to or subservient to the grantor. Thus a spouse living with the trustor would be independent if the spouse were one of three trustees and neither of the other two were related to or subservient to the trustor.)

Grantor's powers. Most importantly, the trustor can retain the power to distribute income to or for an income beneficiary. The trustor may also hold the power to accumulate such income. Both powers may be retained by the trustor either as trustee or individually.

Ordinarily, the trustor would retain these basic powers as trustor and name another person or entity as trustee. The trustor's bank could, for example, become trustee and hold all the powers necessary to administration except the power to distribute the income. The bank could collect and hold the income for distribution pending receipt of instructions from the trustor.

Where the trustor retains the power to accumulate income, he faces other problems. He cannot apportion the income among beneficiaries (that is, specify what portions are to go to which beneficiaries) because in so doing he might accomplish what is called an indirect apportionment. This means that he might, by withholding income from a current beneficiary, favor a beneficiary who will be later entitled. Note one exception to the rule prohibiting apportionment by the trustor/trustee: The trustor does have the right to specify in the trust agreement the sizes of the shares of accumulated income that will be distributed upon termination of the trust.

The trustor can retain other powers when he names himself a trustee. He can retain the power to distribute accumulated income if the beneficiaries are charities that qualify under federal law. The trustor can also retain a discretionary power to apply short-term trust income for the support of someone, other than his spouse, for whom he has direct support responsibilities, for example, a ten-year-old son.

It has generally been held that the trustor of a short-term trust should not control the trust corpus. Where he attempts to do so, he enters a gray area in which the corpus may be viewed as a gift and taxed as such, depending on its magnitude. Retained powers to distribute short-term trust principal raise yet another question: whether they threaten to encumber the trustor's reversionary rights—that is, the rights to resume full ownership of the trust property.

Persons considering short-term trust have noted this ruling with understandable irritation. They claim, properly, that they are relinquishing essential ownership use rights in the principal for ten years or more. Needless to say, the Internal Revenue Service does not buy the objection. The trustor unwilling to surrender the legal title to the trust corpus for ten-plus years should consider some other means of assisting the beneficiary—or so states the IRS.

Powers of trustee other than trustor or spouse living with trustor. Most importantly, the trustee who is neither the trustor nor a spouse living with the trustor can distribute the trust income among the beneficiaries. The trustee has this power whether the beneficiaries have been named individually or as a class. Even the trustee who is subservient to the trustor, such as the trustor's adult

son, may retain the apportionment power, but the power must be limited by a reasonably definite standard.

What constitutes a definite standard? Some of the more common standards, as given in trust documents, include:

- The maintenance, medical care, or education of the beneficiaries.
- The beneficiaries' reasonable support and comfort.
- The maintenance of an accustomed standard of living.
- An emergency.

The trustee must remain accountable for his income distribution decisions under the trust terms. Thus, the standard that might otherwise be considered definite and acceptable would be rendered unacceptable if the trustee's decisions were stated as final. The finality of the decisions would leave the beneficiaries no recourse in the event of a poor or unjust decision.

For example, a trustor might include in the trust agreement a standard calling for provision of medical care as needed for several beneficiaries. The trustee may decide that one beneficiary needs all the trust income. The trustee may have been mistaken in his judgment; but if he makes his decision final, the deprived beneficiaries would theoretically have no recourse.

Other powers granted to a trustee who is neither the trustor nor a spouse living with the trustor include those normally held by trustees. These will be discussed in more detail in a later chapter.

Powers that independent trustees may hold. As noted earlier, a trustee may be termed independent when he is neither the trustor nor a person related to or subservient to the trustor. When there are multiple trustees, they are to be considered independent when none is the trustor and when no more than half of them are either related to the trustor or subservient to him.

The independent trustee in a short-term trust has, once again, the powers normally granted to and exercised by any trustee. This rule applies virtually without exception.

Genuinely independent trustees may receive very broad powers under the trust agreement. The powers may apply to both corpus and income, but in the normal course of events, they should not confer the authority to distribute the short-term trust corpus. Inclusion of a clause permitting such distribution could well raise

the question of the size of the gift and of its effect in making the trust principal subject to gift taxes.

By contrast, the powers that truly independent trustees may hold over income have few limits. The trustee may even hold the power to "sprinkle" the trust income, as under an actual "sprinkling" trust, to be discussed later. The sprinkling provision gives the trustee the power to distribute income among several beneficiaries as he sees fit. The trustee may also accumulate trust income for later distribution.

The powers that can be conferred on the trustee under a short-term trust depend, obviously, on the identity of the trustee. That factor alone suggests the need for careful planning, and usually expert advice, when a short-term trust is contemplated. Proper assignment of powers to the trustee can free the trustor of any concern that he may become subject to taxation because of the way in which income is distributed to beneficiaries.

ADMINISTERING THE SHORT-TERM TRUST

The success of the short-term trust as a tax shelter depends on a number of factors other than those listed above. For example, the trustor will be taxed on the trust income if he has established the trust in such a way that the trustee or some other person dealing with the trust property does not receive adequate compensation.

The trust must also be created, as indicated, to terminate at least "ten years and one day from the date hereof" unless the beneficiary should die before the lapse of that time. Yet even in an irrevocable short-term trust, the trustor may retain the right to extend the trust period.

Two other basic terms of the short-term trust agreement should be specified. First, the trustee is charged with distributing the net income from the trust principal "to the use of . . . the beneficiary . . . until the termination of this trust." Second, the terms should state that the trustee is required, on termination of the trust, to "transfer, pay over, and distribute the principal of this trust fund . . . to the Settlor."

Other provisions may be included against the possibility that the trustor will no longer be living on termination of the trust. Typi-

cally, the trustee will be empowered to turn the principal over to the settlor's estate.

Proper administration of the short-term trust calls for attention to a number of other practices and requirements.

WHEN THE TRUST BEGINS

The trustee has the initial task of fixing the date on which the trust period begins. That date may be established readily if the trustor is also to act as trustee. In this case, the trustor simply states in the trust agreement that, as of such-and-such a date, he is holding the assets in trust.

The task becomes more difficult where another person or entity is named trustee. The trust agreement and all other instruments supporting the legal transfer of the assets should be made on the same day, and that day becomes the day on which the trust period begins.

The supporting instruments could include any or all of the following:

- Registered securities.
- Bearer securities.
- Assignments of leasehold interests.
- Assignments of mortgages.
- Deeds to real property.
- Assignments of other property rights.
- Note property endorsed.
- A check for cash.

Once all the pertinent instruments are in hand, the trustee should take other steps at once. The trustee should, for example, have all the instruments notarized that require it and should open the books of account on the trust, at the same time crediting to the principal any income received up to the date on which the trust begins. The trustee should also notify all interested persons including those who may have become obligated to the trust, that the trust has been launched.

Normally the trustee would also inform the beneficiary of the terms of the trust unless that has been done already. The trustee would make a record of the trustor's cost basis and complete an

investment review of the assets. If any changes appear necessary, these would be noted. The trustee would record that the assets are suitable for this particular trust.

Now the trust can be considered officially in being. But the trustee has still other tasks—for example, deciding how the beneficiary's income will be handled. The income should be distributed to the beneficiary at regular intervals and in accordance with the terms of the trust. The terms may specify that all the income is to be paid directly to the beneficiary. Alternatively, the trustee may have discretionary power either to distribute the income to or for the beneficiary or to accumulate it for him.

Most trustees would bring the beneficiary into the decision on income distribution. The income would, in other words, be distributed according to the beneficiary's desires, and an annual accounting of all payments would be made.

In rare cases, a trustee may have the power to apportion trust income among two or more beneficiaries. Under these circumstances, the trustee will usually obtain the agreement of all the beneficiaries on the selected method and on the amount to be distributed to each beneficiary. The trustee will also keep careful records indicating why the income is being distributed unequally and what portion is to go to whom.

A trust agreement may include an exculpatory clause. Such a clause absolves the trustee in cases of simple—but not gross—negligence. The exculpatory clause does not relieve the trustee of the obligation to follow sound practice in the discharge of trust responsibilities. In a sample case, a trustor placed 20,000 shares of ABC Corporation stock in the short-term trust corpus. The trustor notified the trustee that the closely held ABC Corporation might refuse to furnish complete financial information on its operations. The trustee failed to take the necessary steps to ascertain whether the corporation would actually furnish the needed information. He was subsequently held to be negligent.

Where two or more trustees have responsibilities under a short-term trust agreement, they should prepare and sign a written agreement indicating which trustee will discharge the various duties. These could include holding the assets, keeping records, preparing accountings, and making collections and disbursements.

THE TRUSTEE'S GENERAL DUTIES

From the moment the short-term trust comes into being, a kind of blanket obligation governs the actions of the trustee. The obligation may be summed up by the phrase "undivided loyalty" to the trustor and the beneficiary.

This rule applies generally where trusts are concerned. It means that the trustee cannot borrow or buy from the trust, sell his own property to it, make an investment for himself when he should have made it for the trust, or use trust assets as collateral for a debt. Nor can he deprive the beneficiary of income rightfully due him even though the income may be credited to corpus.

Detailed information on the duties and powers of trustees in general will appear, as noted, in a later chapter. But it should be pointed out that the trustee of the short-term trust has to pay somewhat more attention to the trustor's wishes than would a trustee under a different kind of trust agreement. The trustor may have given the trustee full discretionary powers under the agreement, but almost inevitably the trustor will continue to regard the corpus as his property, since he will recover it at some future date.

The difference just cited has practical effects. In the short-term trust, the trustee may consult with the trustor; but in deferring to the trustor's wishes, the trustee may be opening up the possibility that the tax authorities will attribute trustee-like powers to the trustor. The trustor could then become liable for taxes on the trust income.

The trustee must, in brief, tread the fine line between cooperation with the trustor and discharge of his trustee responsibilities to the beneficiary.

The prudent-man rule. The prudent-man rule, already mentioned, gives the trustee of a short-term trust the general guidance needed to make trust investment decisions. But the rule may be interpreted somewhat differently where a short-term trust is concerned, because the investment practices for a trust expected to live for many years may differ from those for a shorter-term arrangement.

In the long-term trust, the trustee might wisely hold both debt obligations and securities in some ratio that appears to him to meet

the prudence standard. A 60-40, 50-50, or similar ratio may be used to determine how much of each type of asset is held.

In the short-term trust, the trustee cannot reasonably expect that the income from equities will increase substantially over the basic ten-years-plus period. Thus, he may invest only in debt obligations that bring in significantly higher income than do the equities.

Investment and maturity dates. The trustee has the responsibility of ensuring that short-term trust assets yield "reasonable, not maximum," income. For that reason, the trustee's investment strategy may depend to some extent on the maturity dates of debt obligations.

An example suggests how trustees make choices between alternatives. A trustee in a short-term trust has an opportunity to buy 5 percent bonds maturing in 20 years. The trust has slightly more than 10 years to run. Weighing the risks, the trustee realizes that the interest rate in the general market may have increased by the time the trust ends. In that event, the value of the bond will be less at the end of 10 years than the amount paid for it.

In such situations, trustees usually attempt to protect themselves. They try to obtain the trustor's consent to buy obligations maturing well after the projected terminal date of the trust, or they purchase obligations that will mature approximately when the trust is expected to end.

Investment yield. Investing for yield is generally viewed as a wise course for the trustee in a short-term trust. That broad guideline does not, however, mean that in all cases the trustee has to invest for yield. He still has to use his own judgment, particularly if equalizing or offsetting factors suggest an alternative course of action.

Once again, in making such decisions, the trustee keeps in mind the nature of the short-term trust. Precisely because it does not endure for many years, the short-term trust lacks an advantage of the long-term trust: Gains or losses from obligations bought at discounts or premiums do not often offset each other.

The trustee of the short-term trust purchases for yield whenever possible. But whether he does so or not, he keeps a careful record of every decision made, every action taken, and the reasons therefor.

Other investment rules affecting the trustees of short-term trusts

follow a logical pattern. Where possible, such taxable gains as those accruing when a bond matures are made the tax responsibilities of the trustors. As in other kinds of trusts, the trustees of short-term trusts do not violate the prudent-man rule when they purchase corporate stocks, but they seek to ensure that the income from these investments will be comparable to the yields from other investments of similar quality. Trustees stand under no obligation to diversify their investments so long as the income will not come under unreasonable risk and the beneficiaries will continue to receive substantially the income that they would receive from other investments.

ADMINISTRATIVE DUTIES DURING THE TRUST'S LIFETIME

The duties of the trustee of a short-term trust require special consideration in two key areas.

- The trustee, within specified limits, distributes, accumulates, or apportions the trust income to or for the benefit of the beneficiaries.
- The trustee both preserves the trust property and keeps it productive.

INCOME ADMINISTRATION

Apportioning the income from a short-term trust represents a uniquely challenging task for the trustee. The trustee who is presumed to be subservient to the trustor must in particular exercise the apportioning prerogative with meticulous care. If he fails, even unintentionally, to apportion according to the trust terms, he may be committing a breach of trust.

For example, a trustor named his son trustee of a short-term trust created for the three orphaned children of the trustor's sister. The trustee was given the power to apportion the trust income among the children as needed. Initially, the son-trustee had few apportioning problems. He simply distributed the income equally to his father's niece and two nephews, his own younger cousins. After one beneficiary married, the trustee distributed one-half of the trust income to the married beneficiary and the remainder to the other two. A second beneficiary then married. The trustee

decided to pay 40 percent of the annual income to the two married beneficiaries. The remaining 20 percent went to the third beneficiary.

The trustee in this case was running the risk that he might be committing a breach of trust. He risked a finding in equity court that maintenance of a beneficiary does not or need not involve support of the beneficiary's family. Where a subservient trustee has arbitrarily apportioned the trust income, he may be causing the trustor to be taxed on that income.

The independent trustee would not face a similar danger. This trustee may have unrestricted power to apportion or sprinkle income under the terms of the trust agreement. He may exercise that power without suggesting by his decisions and actions that his conduct was influenced by the trustor.

Where the trustee of a short-term trust has sprinkling powers, the trustor usually had special reasons for specifying those powers in the trust agreement. He may, for example, have believed that the beneficiaries' needs would change from time to time. The trustor will not usually have tax reasons for including the sprinkling clause; rarely in a short-term trust will the beneficiaries have enough outside taxable income to make sprinkling effective as a tax reduction measure.

PRESERVING THE TRUST

The trustee of a short-term trust will normally carry out a periodic review of the trust's assets. In doing so, he will be discharging his duty to preserve the trust and keep the trust property productive.

This trustee will be taking into consideration two factors that would not be pertinent in other trust arrangements. First, he will keep in mind that the trust assets will revert to the trustor when the trust ends. Second, the trustee will make allowance for the fact that the trustor will be taxed on any capital gains realized by the trust.

The review of the trust assets involves detailed, careful record keeping. An investment review sheet (see Exhibit 3) or some similar device may be used as a summary memorandum. In addition, the trustee will have a separate file for each of the trust assets, containing information showing the history of the particular asset to date.

Exhibit 3. Investment review sheet.

Trust No. 1234		John Doe—Short-Term Trust				Date	
<i>Bonds No.</i>	<i>Description</i>	<i>Cost Basis</i>	<i>Book Value</i>	<i>Market Value</i>	<i>Income</i>	<i>% of Cost</i>	<i>% of Market</i>
10	\$1,000 bonds of XYZ Corp. 7% ^s , 76	\$ 10,300	\$ 10,240	\$ 10,250	\$ 640	6.2	6.24
Note: Premium amortized @ \$60 a year							
<i>Stocks No.</i>							
100	Shares X Corp. com.	\$ 900	\$ 1,000	\$ 1,200	\$ 60	6.7	5
Diversification:							
Bonds	\$102,000	74%					
Stocks	34,000	25					
Cash	2,000	1					
Total	\$138,000	100%					

Source: E. William Carr, *Short-Term Trusts* (Englewood Cliffs, N.J.: Prentice-Hall, 1973), p. 170.

The trustee seeks to keep the trust productive at all times. He remains current on the trust assets and their status and keeps track of cash as it enters the trust corpus from any source. He takes action to invest such cash at the earliest possible moment consistent with prudent investment practices. After investing, the trustee obtains the documentation or indicia of ownership, including stock certificates.

The trustee's responsibility extends to the smallest units of trust income and principal. For instance, after making an investment, the trustee may find that \$600 is left over in the corpus account. Since this amount might not be adequate for a suitable security purchase, the trustee will generally place it in an insured bank savings account or a savings and loan account so that it produces interest. The interest is held for the beneficiary. It may total only \$30 or \$40, but it represents trust income and is therefore important.

Chapter 8

MISCELLANEOUS TRUSTS

No definitive taxonomy of trusts exists. One reason is that new trusts, or variations on old trust formats, are coming into being continually. Thus, different authorities have developed their own lists of trust forms, characterizing each type according to key provisions or basic effects.

Some important kinds of personal trusts have already been described. These include the charitable remainder trust, the insurance trust, and the short-term trust. Those that remain to be described range from trusts that are in relatively common use to others that are occasionally used for one special reason or another to a few that are hardly more than descriptive names.

Very importantly, it should be noted that the terms of a trust make it what it is. A single clause or paragraph may, for example, distinguish the sprinkling trust. In some cases a single trust instrument may contain terms that place it in more than one trust category. For example, a short-term trust agreement may give the trustee the power to sprinkle trust income.

Since the present chapter discusses a number of different kinds of trusts, it will be useful to note the trusts that fall in the three categories cited.

1. *Commonly used trusts.* These include, for the purposes of this book, the foreign, the generation-skipping, the grantor, the marital deduction, the pour-over, the power-of-appointment/discretionary, the sprinkling, and the SuperTrust.

2. *Occasionally used trusts.* Among those that are less used today, or that have already been partly described, are the blended,

the Massachusetts, the protective, the support, and the Totten trust.

3. *Rarely used, business, and special trusts.* The final grouping includes some trusts that have utility value in specific situations. Those described in brief terms are investment, real estate investment Ohio land, and liquidating trusts—all business forms; employee trusts; and special trusts, such as the accumulation and self-employed retirement trusts.

COMMONLY USED TRUSTS

For the most part, the trusts in common use, aside from those already described, are revocable living trusts. But many others are established as testamentary or irrevocable trusts.

FOREIGN TRUSTS

Basically, a foreign trust is a trust that exists outside the United States for the benefit of U.S. beneficiaries. The foreign trust may be revocable, but the irrevocable form appears to be more common.

A trust will generally qualify as a foreign trust if it meets four criteria:

1. It was created in a foreign country, is subject to the laws of that country, and has a corpus that is controlled by a trustee in the foreign country.
2. Its trustee is a foreign individual or corporation not engaged in trade or business in the United States.
3. The trust assets are located outside the United States, preferably in the country in which the trust was created.
4. The trust is administered in the foreign country in which it was established.

The foreign trust must also be recognized as a trust under the Internal Revenue Code. That means it must, in the words of the code, be shown that

the purpose of the arrangement is to vest in trustees responsibility for the protection and conservation of property for beneficiaries who cannot share in the discharge of this responsibility, and, therefore, are not associates in a joint enterprise for the conduct of business for profit.

KINDS OF TRUSTS

The literature on trusts contains references to so many different kinds of trusts that even a partial listing poses a difficult task. Some trust forms have become obsolete; others are little used. Some of the types, by purpose or function, are:

Accumulation	Naked
Annuity	Ohio land
Blended	Parol
Business	Parol constructive
Charitable remainder	Personal
Closed-end investment	Precatory
Common-law	Presumptive
Complete voluntary	Private
Constructive	Protective
Continuing and subsisting	Pour-over
Direct	Power-of-appointment/ discretionary
Directory	<i>Pro tanto</i>
Discretionary	Purchase money
Donative	Pure
Dry or simple	Quasi
Educational	Real estate investment
Employee	Religious
Executory	Resident
Express	Resultant
Foreign	Resulting
General	Revocable
Generation-skipping	Secondary
Gift	Secret
Going concern	Self-employed retirement
Grantor	Sequential
Holding	Shifting
Honorary	Short-term
Illusory	Spendthrift
Implied constructive	Sprinkling
Insurance	Statutory
Investment	Strict
Involuntary	SuperTrust
Irrevocable	Support
Legal	Technical
Liquidating	Tentative
Marital deduction	Testamentary
Maryland	Totten
Massachusetts	Vested

The foreign trust enjoys tax advantages because of its special status. In general, if it meets the requirements of a trust, it will be treated for federal income tax purposes as would a nonresident alien who is not engaged in a trade or business in the United States. As a particular advantage, the foreign trust can accumulate larger amounts of capital gains than could a comparable U.S. trust, because the foreign trust will not be subject to tax on its capital gains. It will thus retain full use of the tax dollars that would otherwise have been paid to the federal government.

Where the foreign trust accumulates substantial amounts of ordinary income in the form of dividends and interest, it may have another advantage. It may be able to defer tax payments on such income. However the trust functions, the foreign trustee has to maintain precise records so that the U.S. beneficiary can compute his income tax after the accumulation period has ended. That period may run for a long time—in many cases, years. Without adequate records, the beneficiary may be required to treat the entire distribution as taxable net income.

Very complex tax and other regulations surround the creation and operation of a foreign trust. Thus, formation of the trust requires extensive advance preparation and consideration. Advantages and disadvantages, actual or potential, should be examined. In particular, some of the tax effects of certain investments, particularly those made in the United States, should be analyzed. Some examples follow.

Income from foreign sources. The foreign trust may profitably make investments that produce foreign-source income. In effect, such investments may not be taxable in any country until the trust makes distributions of one kind or another.

Real estate. A less favorable outlook faces the foreign trust investing in U.S. income-producing real estate. Ownership and operation of such property will usually be regarded as engaging in a U.S. trade or business. The income from the property and the gains realized from the property's sale will be subject to U.S. income tax.

Stock in a start-up corporation. Such stock may advantageously be purchased if it is being offered by a domestic corporation that will eventually be sold for cash. The stock, it may be presumed, will not have appreciated substantially in value by the time it is transferred

to the foreign trust; thus, it will escape all but minimal U.S. excise taxes.

U.S. partnerships. A foreign trust that qualifies legally as a partner in a partnership engaging in a U.S. trade or business will itself be regarded as so engaged. As one of a number of limited partners investing as a partnership in U.S. securities, however, the foreign trust may avoid federal taxes. In this case, it will not be viewed as engaging in a U.S. trade or business.

GENERATION-SKIPPING TRUSTS

Usually a testamentary trust, the generation-skipping format can also be built into a living trust. The arrangement is most widely used where a trustor's children have substantial estates of their own. Under these circumstances, the trustor may decide to skip his children's generation and leave his estate to his grandchildren.

The generation-skipping, or bypass, trust has obvious and substantial tax advantages. For one thing, it does not increase the taxable income of the trustor's children. More positively, in bypassing the children's large estates, and avoiding those estate taxes, it postpones a second such tax. That tax may, in fact, be postponed until the grandchildren die.

The trustor's property could be left outright to the grandchildren. But that method may be inadvisable for specific reasons. Often, for example, the grandchildren will be too young to handle the inheritance when the trustor dies. A trust solves that problem by introducing the necessary flexibility. If the trustor has more than one child, he may create a separate generation-skipping trust for each of them. The trustor's children may each be named a trustee under the separate trust agreements—a common practice.

The generation-skipping trust has three main purposes. For one thing, it enables a trustor, fearing that his own child might waste the assets collected at the cost of sweat and toil, to skip this child and pass his estate to his grandchildren. In many cases, too, the trustor's children have sizable estates of their own; a gift would simply increase the taxes they would have to pay. For another thing, a trustor may want to prevent the spouse of his child from obtaining any part of the trustor's estate. For a third thing, the generation-skipping trust allows the trustor to pass his estate on to

his grandchildren without the imposition of another death tax on the death of his own child.

The Tax Reform Act of 1976. To some extent, TRA '76 reduced the potential of the generation-skipping trust as a tax advantage. The act imposed a new tax on certain kinds of generation-skipping trust transfers. Primarily, it imposed a tax on a trust having younger-generation beneficiaries in more than one generation. The tax must be paid out of the trust property. The tax bite approximately equals the estate or gift tax that would have been levied if the property had been transferred outright. But generation-skipping trusts nonetheless offer some tax-saving possibilities.

Tax law loopholes. The loopholes in TRA '76 that promise tax relief grow partly out of the law's definitions. For instance, the trustor may establish a trust for a spouse for life and direct that the remainder should pass to a grandchild outright. That format would not bring the trust within the law's purview because there are not two or more generations of beneficiaries younger than the trustor: The trustor's child's estate would be bypassed.

Other possibilities exist. Importantly, up to \$250,000 can be transferred tax free to each of a trustor's grandchildren. The rule may be summarized roughly as follows: Transfers to grandchildren by trust are not subject to taxation to the extent to which the total transfers do not exceed \$250,000. But the transfers must be made through a transferor, such as the trustor's child, who is also the grandchild's parent. If the trustor has two children, for example, and each of them has children, the trustor would be able to transfer \$250,000 to each set of grandchildren tax free.

Some examples of trusts that escape the generation-skipping transfer tax may be noted. A trust for a spouse and children that goes to the children on the spouse's death would not be taxed; nor would a trust for a child that goes to the child's offspring or, if there are no offspring, to the trustor's other children. A trust solely for grandchildren would not be taxed because only one generation benefits under the trust terms.

The generation-skipping tax became effective for trust transfers taking place after April 30, 1976. Thus, the new law was not intended to apply to any irrevocable trust in existence on that date. Under one proviso, no changes or additions could be made after that date.

Where a revocable trust was created before April 30, 1976, the trustor was given until January 1, 1982, to examine the trust agreement and decide whether it required changes.

GRANTOR TRUSTS

The Internal Revenue Code lays out in great detail the income and estate tax laws and regulations that cover grantor trusts. In essence, these laws and regulations define the grantor trust as one that is owned or controlled by the trustor. Because the trustor is considered to be the trust owner, the trust income is taxed to him.

In the grantor trust, the trustor (or grantor) has retained such powers that the trust becomes invalid for income tax purposes. He may not have retained those powers himself; if he has given the powers to another person whose actions may be attributable to the trustor or who may be subservient to the trustor, the trustor will still be considered the owner and will be taxable under the Internal Revenue Code.

The complexity of the laws and regulations on grantor trusts makes it difficult to describe such trust arrangements in brief. The following are some of the more important circumstances under which a trust will be considered a grantor trust:

- Where the trustor retains a reversionary interest in the corpus or income and the reversion can become effective within ten years after the transfer of the property to the trust. (A reversionary interest, of course, means that the corpus or income can come again under the trustor's ownership control.)

- Where the trustor retains the power to dispose of either the trust property or the trust income without the consent of anyone whose interests run counter to the trustor's own.

- Where the trustor can exercise administrative control of a trust for his own benefit instead of that of the beneficiaries. The trustor, for example, may retain the right to borrow from the trust without adequate interest or security, or to direct the voting of stock owned by the trust, or to reacquire the trust property on condition that he substitute other property of approximately equal value.

- Where the trustor has the power to revoke or alter the trust. But that general rule will be superseded if revocation can take place only with the consent of an adverse party. If ten years or more

must elapse from the inception of the trust until the power to revoke can be exercised, the trustor will not be taxed on the trust income for that ten-year period, but he will be so taxed after the ten years unless he surrenders the power of revocation.

- Where the trust income or part of it may, at the trustor's discretion, be distributed to him, held or accumulated for him, or applied to such personal expenses as the payment of life insurance. A similar provision would apply if the trustor's spouse were the income beneficiary instead of the trustor.

It should be noted that a testamentary trust can never qualify as a grantor trust, because the testamentary trust cannot take effect until after the trustor's death.

MARITAL DEDUCTION TRUSTS

The marital deduction has become a fundamental tool in estate planning. Essentially, the deduction is calculated according to a person's gross estate at his death, less deductions for debts and administrative expenses, taxes, and losses. The marital deduction allows the gross figure to be further reduced by the value of any property left to a spouse up to a maximum deduction of \$250,000 or 50 percent of the gross value figure, whichever is greater.

For example, if John Lavin's trust agreement utilizes the deduction, it would first direct that Lavin's estate be divided on his death into two parts. One part would be placed in Trust A for the benefit of the trustor's wife, during her life; the other would go into Trust B. Trust A is the marital deduction trust or widow's trust. Trust B is generally referred to as the family trust, the residuary trust, or the nonmarital trust.

All taxes, charges, and expenses claimed or levied against Lavin's estate would, on his death, be paid out of Trust B. The balance remaining in Trust B would be held in trust and used according to the judgment of the trustee for Mrs. Lavin's care, maintenance, and support as required. On the wife's death, the corpus remaining in Trust A would go to beneficiaries named by the wife. This part of the Lavin estate would at that time be taxable.

Trust B would devolve at the wife's death on beneficiaries named in the trust agreement by the trustor. These beneficiaries would usually be the children of the trustor and his spouse. Trust B would

not be taxable on the death of the surviving spouse, because the trustor would have named the beneficiaries.

Basic conditions. Some basic conditions must be met if the marital deduction trust is to have validity. The surviving spouse must have the right to claim, for life, all the income from a specific portion of the trust corpus. That income must, by the terms of the trust, be payable at least annually. The surviving spouse must be empowered to appoint—that is, to claim legally—to herself or her estate the trust property or the specific portion assigned to her.

The surviving spouse's interest, it should be noted, cannot be terminable. That spouse must have the power to appoint the trust corpus, for example, at any time by will or instrument executed during life. No other person may retain the power to appoint the estate to someone other than the survivor.

The tax savings. A marital deduction trust is generally viewed as a means of protecting a surviving spouse or other beneficiary against the consequences of lack of experience or wisdom or against the problems that come with age. But under what is called the two-trust will, some very practical financial effects can be achieved as well.

A two-trust will creates two equal estate portions—Trust A and Trust B. If Lavin's estate totaled \$300,000, each trust interest—the marital deduction trust (Trust A) and the residuary trust (Trust B)—might have a value of \$140,000. On Lavin's death, assuming that he died first, the marital deduction trust would pass to his wife tax free. Because of the \$47,000 tax credit, which exempts estate portions valued at less than \$175,625 (as of 1981), no tax would be levied on the residuary trust.

But look what happens when Mrs. Lavin dies. At that time only the marital deduction trust would be exposed to taxation. Again the \$47,000 credit would offset the tax. Because it is not considered part of the wife's taxable estate, the residuary trust would pass untaxed to other members of the family.

Very commonly, a married couple will hold all property in joint tenancy. If Lavin died, not having set up a trust, and all of his and his wife's assets were held jointly, the assets would all be taxed as part of his estate. Then they would pass to Mrs. Lavin, to be taxed again on her death.

The principles in the Lavin case parallel those of the widow trust

Exhibit 4. Estimated federal estate taxes for husband and wife.

Estate	If Husband Leaves Simple Will			If Husband Leaves Will with Tax-Saving Trusts			Total	Total	Saving with Trusts
	Husband's Tax	Wife's Tax	Total	Husband's Tax	Wife's Tax	Total			
\$ 200,000	\$ 0	\$ 6,600	\$ 6,600	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 6,600
250,000	0	21,400	21,400	0	0	0	0	0	21,400
300,000	0	37,200	37,200	0	0	0	0	0	37,200
400,000	0	68,000	68,000	6,600	6,600	13,200	13,200	54,800	54,800
500,000	21,400	92,209	113,609	21,400	21,400	42,800	42,800	70,809	70,809
600,000	37,200	119,524	156,724	37,200	37,200	74,400	74,400	82,324	82,324
700,000	52,600	147,442	200,042	52,600	52,600	105,200	105,200	94,842	94,842
800,000	68,000	175,104	243,104	68,000	68,000	136,000	136,000	107,104	107,104
900,000	83,400	203,677	287,077	83,400	83,400	166,800	166,800	120,277	120,277
1,000,000	98,800	232,601	331,401	98,800	98,800	197,600	197,600	133,801	133,801
1,500,000	180,900	378,191	559,091	180,900	180,900	361,800	361,800	197,291	197,291
2,000,000	265,600	533,803	799,403	265,600	265,600	531,200	531,200	268,203	268,203

case in Chapter 1, but the tax effects are shown here in greater detail. They are also shown in Exhibit 4 for a broader range of estate sizes.

As the exhibit indicates, the two-trust will arrangement has major advantages. In the Lavin example, the net result of the two-trust will emerges as a tax saving of \$37,200.

A and B trusts need not always be identical in size. In many cases, it proves more advantageous to assign different sums to the two trusts. This occurs where a smaller sum assigned to the trust estate of one spouse reduces the postdeath tax liability on that estate to a low figure or eliminates it entirely.

Sequential trust. One form of the marital deduction trust has been called a sequential trust. The A and B trust estates are, essentially, used or used up in sequence. Trust B accumulates income while both income and principal from Trust A go for the widow's support and maintenance.

In an actual case, widow Joan needed \$20,000 a year to be able to live as she was accustomed to. By the terms of the sequential trust, she received \$10,000 from the Trust A income plus \$10,000 annually from the Trust A principal, which was initially \$200,000. Meanwhile, Trust B accumulated income. The tax and other effects may be itemized as follows:

- The withdrawals of principal from Trust A were not taxable. Thus, Joan paid taxes only on the income distributions of \$10,000 annually.
- Because of the withdrawals from Trust A principal reduced that corpus steadily, on Joan's death the federal tax on her estate would very likely have been reduced to zero.
- Regardless of how Trust B grew, if Joan did not add to it while alive, it would not be taxable in her estate on her death. In most states it would also avoid probate.
- If Joan lived long enough to exhaust the Trust A principal, she would start receiving \$20,000 a year from Trust B. All of that income would be taxable.
- Accumulated income paid into Trust B would be taxable in the year in which it was earned.

POUR-OVER TRUSTS

While not strictly speaking a testamentary trust, a pour-over trust can accompany a true testamentary trust or will and ac-

compish important purposes. The pour-over works as follows.

When preparing a will, the testator creates a living trust. The trust terms specify the ways in which the trust property is to be disposed of—that property may include anything of value to be received at a later date, such as a stamp collection, a yacht, a car, or valuable Hummel figurines. The will that creates the pour-over trust can be a simple document. It need only provide that all the property belonging to the testator at the time of his death go into the trust. The will need not then be changed; it provides for disposition of the entire estate. But the terms of the trust agreement itself can be amended or altered at any time before the testator's death.

Major advantages accrue from such an arrangement. The living trust can be funded with a few dollars, perhaps \$50 in cash. In transferring the decedent's estate to the trust, the will effectively keeps off the public record the details of the disposition of the decedent's property. The trust instrument does not have to be recorded, though it may be and in some cases is.

Funding the living trust with even a small amount of cash makes it valid. When the estate goes into the trust on the testator's death, the will provisions have been carried out and the estate can be settled. The trust takes over and operates in complete privacy. As with any other trust, the living trust terms can provide for immediate disposition of the estate or for extension into the future under specified conditions.

Since the property going into the living trust is not going to a surviving spouse, it cannot qualify for the marital deduction unless the trust instrument contains specific provisions that qualify it as a marital deduction trust. Aside from this caveat, the pour-over trust produces many effects of the testamentary trust, combined with key advantages of the living trust.

Privacy may rank as the pour-over trust's most prized effect. A man with a substantial estate may provide secretly for an illegitimate child. A woman with an estate developed over years may include a lover among her beneficiaries. A single, gay testator of either sex may do the same. The situations may be multiplied endlessly. Not surprisingly, many persons in the public eye seek privacy in making dispositions of their estates.

POWER-OF-APPOINTMENT/DISCRETIONARY TRUSTS

By definition, a power of appointment confers the right to designate the beneficiaries who will receive property under a trust. The right may be exercised by will or deed. Usually, a person who has a life interest—a life tenancy—in the property will hold the power of appointment. But the life tenancy and the right to designate beneficiaries may be divided: One person may be the life tenant and another may have the power of appointment. The latter would then designate the recipient of the property after the life tenant's death.

The power of appointment is always discretionary: It carries the right to use judgment in the exercise of the power. Thus, the trust that confers a power of appointment on any person has a discretionary element. That element, of course, may also distinguish many of the powers granted to a trustee under a typical trust instrument.

What, then, is a power-of-appointment trust? Essentially, it is any trust that grants such a power to anyone; it may or may not be a testamentary trust. A trust agreement will typically grant a power of appointment to a surviving spouse. In fact, as noted earlier, a trust may qualify for the marital deduction if the surviving spouse is granted a power of appointment. But in this kind of trust, the power may be granted to someone besides the survivor.

A person holding a power of appointment faces some tax hazards. For example, where this person also holds the power to vest trust corpus or income in himself—that is, to take title—he will have to pay taxes on the income from the trust property. If he holds a general power of appointment, the trust property would be considered part of his taxable estate when he dies. The general power gives the holder the right to dispose of the property to his estate, his creditors, himself, or the creditors of his estate.

The holder of a power of appointment may not know in advance that he is going to receive the power. Thus, he will not often be able to accept it or refuse it, but he can, after receiving the power, disclaim or renounce it. Renunciation of the power of appointment must be made within a reasonable time after the holder learns of its existence. He would have good reason to renounce it in cases where he faces greater estate tax liabilities because the property is in his estate.

Releasing or exercising the power does not necessarily lead to estate tax liability; the holder has only to make certain that he does not retain any rights that would cause a transfer of his own property during his lifetime to be included in his estate. Tax liability may also be avoided if the trust agreement specifies that the power cannot be exercised by the holder for his own, his estate's, or his creditors' benefit.

SPRINKLING TRUSTS

Any trust other than a marital deduction trust may provide that the trustee have the discretionary power to distribute income among a number of beneficiaries. The trustee "sprinkles" the income as he sees fit.

Whether the trust is an inter vivos or a testamentary trust, the sprinkling format has great advantages. Most importantly, perhaps, the trustee can equalize the financial situations of the beneficiaries. Larger portions of the trust income can be paid to those who need it most. In the process, the trustee may save substantially on income taxes by paying income to those beneficiaries who fall in lower tax brackets.

The sprinkling principle does not apply only to the power to distribute income. It may also be extended to cover discretionary powers to distribute corpus under specified conditions.

The sprinkling trust may function like the generation-skipping trust. A trustor may create a trust for each of his children, giving each of them the power to sprinkle income or corpus among their children. Distributions may be made to other trusts as well as to living beneficiaries.

As regards the tax-saving potential of the sprinkling trust, a general rule applies: The greater the number of income beneficiaries, the greater the tax savings. But each beneficiary must be a separate taxable entity.

THE SUPERTRUST

The so-called SuperTrust has been described by its author, Frank B. Weisz, as a special kind of irrevocable insurance trust. The subject of extensive promotion in 1979, the SuperTrust had not at that time been tested in court proceedings. For that reason, it

cannot be stated conclusively that the SuperTrust would be upheld by the courts as a valid trust. But the following typical case indicates how the SuperTrust would work.

Mrs. Lula Johnson anticipates inheriting her husband's gross estate totaling \$800,000. Of that sum, \$300,000 will be life insurance. Mrs. Johnson has no property of her own.

George Johnson, husband of Lula, decides to use a SuperTrust. He transfers the life insurance—\$300,000—into an irrevocable life insurance trust that is created in such a way as to avoid both George's and Lula's estates. This becomes the SuperTrust. George then, with the \$500,000 remaining in his estate, draws up a marital deduction will. The will includes a clause specifying that the marital deduction will be the maximum required to bring George's estate taxes to their lowest point.

To save on state inheritance taxes and administration costs, George puts his bequest to his wife in another trust. This bequest in trust gives Mrs. Johnson a life income and a testamentary power of appointment. The will also contains a pour-over provision. Under this clause, any unused portion of the testamentary trust corpus would be deposited into the SuperTrust when Mrs. Johnson dies. The pour-over provision assumes that Lula will not utilize the general power of appointment to dispose of the remaining marital trust corpus.

Lula Johnson would prepare a will containing a pour-over provision ensuring that any property she owns at her death, except tangible personal property, will be joined with the other property in the SuperTrust. If Mrs. Johnson dies before her husband, any property she may have acquired bypasses her husband's estate.

George Johnson's will provides that the remainder of his estate will pour over into the SuperTrust. Both the trust and the will are executed concurrently. While George lives, the provisions of the SuperTrust operate only to the extent necessary to:

- Allow use of the trust principal. To accomplish this, the SuperTrust grants the wife of the trustor, George, the power to make gifts from the principal of the trust to George or his children.
- Make possible payments of the insurance premiums. A

“Crummey provision”¹ accomplishes this goal by empowering the trustee to accept property (funds) from George, notify George’s beneficiaries that they have six weeks in which to claim the property—to a maximum of \$5,000—and, when they fail to do so, to apply the property to payment of the premiums.

- Pay to George’s wife during George’s lifetime the net SuperTrust income. Such a provision makes it possible for the trust, as the entity owning the insurance contract or contracts, to claim the federal income tax deduction for the interest on the accruing policy indebtedness.

Complex? Undoubtedly. Effective? Undoubtedly. Completely unassailable? Possibly. But the IRS could attack the SuperTrust on the ground that George has retained indirect access to the trust assets by controlling his spouse.

Exhibit 5 shows the income tax effects of the SuperTrust when combined with the maximum marital deduction provision.

OCCASIONALLY USED TRUSTS

Trusts that are used occasionally include a number with special purposes or goals. Others are distinguished by the manner in which they are created or by the nature of the property that is placed in trust. The occasionally used trusts include the following, each of which is described in thumbnail form.

THE BLENDED TRUST

A blended trust is created for the benefit of all the beneficiaries as a group. No single beneficiary can lay claim to any particular share of the trust. The trust agreement limits the beneficiaries’ interests in specific ways. As in the spendthrift trust, no beneficiary has an interest that he can sell or assign, and no creditor can reach any beneficiary’s interest.

¹So-called because it utilizes the precedent in the case of *Crummey v. Commissioner*, 22 AFTR 2nd 6023, 397 F. 2nd 82. The court in this case recognized that a trust provision that gives a beneficiary the power to demand immediate possession and enjoyment of trust corpus results in a present interest gift.

Exhibit 5. Combined effects of the SuperTrust and maximum marital deduction provision.*Situation*

Husband has an \$800,000 estate,
\$300,000 of which is life insurance.
Wife owns no property of her own.

	<i>FET^a on Husband's Death</i>	<i>FET^a on Wife's Death</i>	<i>Total</i>
<i>Before Planning</i>			
Husband has simple will	\$ 74,800	\$192,124	\$266,924
Husband owns all insurance (Taxable Estate) ^b	(\$400,000)	(\$725,200) ^c	—
<i>After Planning</i>			
Husband has maximum marital deduction will	\$ 23,800	\$ 23,800	\$ 47,600
SuperTrust owns all insurance (Taxable Estate) ^b	(\$250,000)	(\$250,000)	—
		Savings	\$219,324

^aAssuming all deaths occur after December 31, 1980, when the unified credit is \$47,000.

^bAssuming (for simplicity) no deduction other than the marital deduction.

^cThe entire estate of husband minus the taxes payable at his death.

Source: Frank B. Weisz, *SuperTrust* (Rockville Center, N.Y.: Farnsworth Publishing Co., 1970), p. 117.

THE MASSACHUSETTS TRUST

The Massachusetts trust has also been called a business trust or a common-law trust. It creates a form of business organization useful in carrying on a joint venture or some other business operation. The assets of the Massachusetts trust are held by a trustee, while the owners or contributors of capital—the beneficiaries—hold ownership documents known as certificates of beneficial interest. As in a partnership, creditors may legitimately seek recompense or redress from the owners unless they have been put on notice that only the trust assets can be used in settlement of claims.

The Massachusetts trust may qualify as a corporation. The laws of the state in which the trust is created may give the trust that status. That means the trust has limited liability to creditors. As a general rule, the federal income tax laws applicable to corporations apply to Massachusetts trusts as well.

THE PROTECTIVE TRUST

Like spendthrift trusts, protective trusts seek to keep beneficiaries from becoming the victims of their own inexperience or poor judgment. The protective trust usually comes into being in those states that prohibit or do not recognize spendthrift trusts.

The only basic difference between the protective and spendthrift trusts lies in the uses to which they are put. The protective trust has many uses; in fact, virtually all trusts have some protective clauses. For example, a protective trust might be used to protect a child against possible financial pressures brought later by a spouse or blood relatives. The spendthrift is a specific form of protective trust. It protects an individual beneficiary, or more than one beneficiary, against a tendency to spend money unwisely.

The key provisions of spendthrift and protective trusts are similar. The trustor states that if the beneficiary attempts to transfer his interest in the trust, the trustee can take certain actions. For instance, the trustee can be empowered to use his discretion in paying the trust income to the beneficiary. The effect achieved would be that as long as the primary beneficiary keeps his debts paid and does not abnormally encumber the trust, he will uninterruptedly enjoy the trust benefits.

THE SUPPORT TRUST

In a sense, the support trust ranks as a discretionary trust. But in this case, the trustee has the discretionary power to use the trust income only, and only so much of it as a beneficiary may need to achieve a specific goal—for example, to complete his education.

As with both the spendthrift and protective trusts, the support trust provides that the beneficiary cannot sell or otherwise alienate his interest in the trust. The beneficiary has only a limited interest in the trust in any case; limitations on the power to assign are normal and appropriate. Because the trustee has discretionary powers, the beneficiary, in fact, can receive only what the trustee believes to be necessary to the achievement of the special goal. The beneficiary's interest cannot be reached by his creditors.

THE TOTTEN TRUST

The Totten trust takes its name from a New York court case in which it was decided that a bank account trust can be valid.²

Essentially in this kind of trust, the trustor deposits some of his money in a bank savings account in his own name as trustee for someone else.

Most states recognize the Totten trust, but some have challenged it for obvious reasons. In the typical case, the trustor notifies the beneficiary that the deposit has been made. Thus, most courts infer that the trustor has evidenced a real trust intent. But the trustor retains control of the bank account to the extent that the trust/bank account arrangement can be nullified at any time. That, some courts have said, only means the trust is a revocable living trust arrangement.

What appears to distinguish the Totten trust is its basic effect: Whatever remains in the bank account at the trustor's death goes to the named beneficiary. The trustor may also, while alive, have the bankbook delivered to the beneficiary, further indicating a trust intent.

The Totten trust has been called "the poor man's will." To an extent it does have the effect of a will. But it cannot be viewed as a gift for gift tax purposes. Nor does it deflect taxable income away from the trustor/depositor. In addition, the trustor's creditors can reach the bank account, and the unrevoked balance will be included in the depositor's estate for estate tax purposes.

RARELY USED, BUSINESS, AND SPECIAL TRUSTS

Other kinds of trusts are used primarily where business interests are concerned. In addition, many special trusts have come into being in connection with employee benefits.

BUSINESS TRUSTS

At least four kinds of business trusts should be noted.

Investment trusts. The investment trust offers important advantages to small investors. Because the tax laws provide for reduced or no taxes on trusts, the investor in securities may find it expedient to join an investment trust as a trustor-beneficiary. Thus, he will gain tax advantages that a corporation could not offer.

Real estate investment trusts. The real estate investment trust (REIT) is very similar to the simple investment trust, but it deals

²*Matter of Totten*, 179 N.Y. 112, 71 N.E. 748 (1904).

primarily with real estate, not securities. It became very popular as an investment vehicle in the early and middle 1970s. Investors found that the trust minimized taxes while maximizing profit opportunities, but poor investments coupled with business recessions brought the REIT into disfavor.

Ohio land trusts. The Ohio land trust involves real estate exclusively. Like the investment trust, it enjoys important tax advantages. It resembles closely the real estate investment trust, with some basic technical differences.

Liquidating trusts. In this instance, the trust has been organized to liquidate and distribute a specified range of business or other assets. The trust terminates on completion of the distribution.

Other trusts may serve to protect the interests of shareholders during insolvency proceedings. One such, the voting trust, resembles the liquidating trust closely.

EMPLOYEE TRUSTS

For the most part, employee trusts come into being in connection with such employee benefit programs as pension or profit-sharing plans. The trusts are generally subject to very strict tax rules.

Because they cannot be considered personal trusts any more than business trusts can, the principal kinds of employee trusts are noted only briefly. The pension trust and the profit-sharing trust have the purpose of receiving and handling a firm's pension deductions and contributions. In an employees' stock ownership trust, the trustee has the responsibility for receiving a company's stock for later distribution to qualified employees. A stock bonus trust may be created for the same purpose.

OTHER SPECIAL TRUSTS

Other trust formats qualify as special trusts. Two kinds are worth noting.

The accumulation trust. While severely restricted by law, the accumulation trust still has value in given circumstances. In essence, the terms of the accumulation trust agreement provide that the income is to be retained by the trust until a certain event occurs or until a given period of time elapses. Tax law changes introduced in the 1960s and 1970s imposed severe new restrictions on accumulation trusts. For example, the Tax Reform Act of 1969 con-

tained an "unlimited throwback rule." The effect of the rule was to tax trust beneficiaries on trust income accumulated in taxable years after 1968.

The self-employed retirement trust. The self-employed person can establish a self-employed retirement trust whether he is making contributions under a Keogh Plan or an Individual Retirement Account (IRA). The corpus of the trust is the retirement fund.

WHEN SHOULD YOU CONSIDER A TRUST?

The question of when to consider establishing a trust has no simple answer. The most comprehensive answer sounds too simple: If you have an estate of any substance, or plan to build one, you should consider the possibility of creating a trust.

Fear should not deter you. Yet professional trustees indicate that fear stays the hand and mind of many people who could and should have a trust.

What fear? The fear of losing control of one's property: Surrender of legal title may, to some people, be equated with loss of control.

Distaste for the legal processing that precedes the creation of a trust dissuades others.

The fact is that you may need a trust for a specific purpose, at a specific time of your life, such as a moment of truth or decision or when your estate reaches certain dimensions. Tax avoidance should, as has been noted, probably never be your sole guiding motive. To name one reason: You may severely curtail your enjoyment of your own assets during your lifetime. Thus, other purposes should have equal or greater validity. The life and financial circumstances that can enter into a decision to create a trust can range from physical infirmity to some special purpose, such as the intention to make a gift to charity.

A single factor can be decisive in any given personal situation. You have just bought a home. You have just been named to a high—and high-paying—executive job. You have inherited a fortune. Your husband has become crippled by arthritis and may have

to be provided for in case you, the breadwinner, should become seriously ill or die.

You can draw a parallel between establishing a trust and transferring responsibility in other life situations. A person may decide that he can no longer take the time to paint his home himself. He may renounce other chores that occupy the homeowner's time: hanging storm windows, mowing the lawn, fixing things. He has become affluent and values his time to the point where he would rather read reports while at home than work around the house. So he contracts the work out.

Still later, he may encounter special responsibilities. A child may have a disability, or aging parents may need support and maintenance. At the same time, the Raccoon Club, of which he is a charter member, may be planning a trip around the world. A trust may provide the answer here. In a sense, it makes it possible to contract responsibilities out. Delegation of responsibility may become as simple as hiring a neighbor to mow the lawn—if somewhat more costly.

There are many other situations that suggest the need for a trust. Factors that you should consider when deciding whether to create a trust appear in the special list on the following pages.

PHYSICAL AND MENTAL REASONS

"Creating a trust is a people thing," a veteran trust officer notes. "The individuals who come to me to open a trust account are thinking of themselves in relation to others.

"They may feel that they are slipping a little. They can no longer play croquet, or golf, or tennis. They do not want to become a burden to others—ever. They feel they should provide for the day when their decline has progressed further. They have become aware that we are only here for a moment in time, and they want to retain their dignity.

"It doesn't really matter what their station in life is. One may be wealthy and gay, and may want to take care of a lover. A woman client came to us to set up a trust for her much younger female business partner.

"There's pride here, but there's also unselfishness. I really think there's more of the latter. The father who creates a trust wants his

FACTORS TO BE ACCOUNTED FOR WHEN CONSIDERING A TRUST*

Since creation of a trust represents the culmination of both soul-searching and consideration of many very practical personal factors, a list such as the following may help you move toward a decision. Once you have all the details in one place, you can both plan better and form a more rational judgment regarding a trust.

The Human Data

The Client

Age	Residences
Health	Domicile
Marital status	Service record
Citizenship	Approximate wealth
Occupation	Approximate income by categories
Avocations	Approximate family living expenses

The Client's Family

For each member of the immediate family:

Relationship	Domicile
Age	Approximate wealth
Health	Approximate income
Marital status	Character and personality (a selected group of questions will elicit all that is needed)
Progeny	
Occupation	

Other Potential Beneficiaries

For individuals, similar data as for family.

For charities:

Name
Address
Purpose of benefaction

The Financial Data

Personal Effects

Market value, estimated	Separate listing of special assets, e.g., valuable works of art, collections, etc., each of which may require additional data
Location	
In whose name insured	

Real Estate

Location	Maintenance cost
Nature—residential, home, undeveloped, rental, etc.	Cost basis
Earnings—some added detail may be necessary	Date acquired
	Contribution of spouse to cost
	Encumbrances

How acquired	Market value
How title is held—outright, jointly, in common, entirety	Prospects as an investment

Listed or Traded Securities

Initially, only by groups—i.e., government bonds, tax exempts, other bonds, preferreds, convertibles, commons. Other details may be needed later as to individual items.

Where listed or traded	Cost basis
Type	When acquired
Face amount or number of shares	Income return
	Market value

Closely Held and Untraded Securities

Type and full description	Cost basis
Face amount or number of shares	When acquired
Possibilities of a market	Estimated market value

Full description of the company, including

- State of incorporation
- Status of control
- Nature of business
- Capital structure
- Capital and earnings position
- Prospects as to earnings, growth, continuance of good management, etc.

Partnership Interests

Nature of enterprise	Identity of other partners
Percentage of interest	Prospects
General or limited interest	Value of interest

Single Proprietorships

Location	Value
Nature of enterprise	Prospects

Jointly Held Property

Whether by entirety, jointly, or in common	Date acquired
Extent of ownership	Cost basis
Other owners	Nature of property—detail may be needed
How acquired	

Other Assets

For each of these assets, details that are too specialized to list here in full may be needed.

Cash in banks	Leases, as assets:
Cash in savings accounts	Nature
Cash in Totten trusts	Location
Accounts receivable	Income
Notes receivable	Operating cost
Mortgages	Length of term
Life insurance	Special terms

Patents, trademarks, etc.	Remainder interests in existing trusts
Deferred compensation rights	Other interests in estates and trusts, such as powers of appointment
Vested rights in pension and profit-sharing trusts	Other distributive or discretionary rights under trusts
Stock options	After-death receipts expected
Oil interests—a difficult form of asset, requiring expert analysis and advice	Tax refund claims
Stock bonus and similar rights	Expected inheritances

Debts and Obligations

Full, necessary details on debts and obligations, including contingent obligations should be listed.

Documentary Materials

Tax Materials

Last income tax return filed	Last gift tax return filed
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Fiduciary Documents

Wills of others which may have a bearing	Trusts of others which may have a bearing
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Life Insurance and Annuity Policies

These should be accompanied, if possible, by an analytical digest.

Contracts and Other Documents

Premarital agreements	Partnership and other business agreements
Matrimonial waivers	Deeds
Divorce and separation agreements and decrees	For any closely held corporate interest, partnership, or sole proprietorship:
Executive pay plans in which the client has an interest, including:	The last balance sheet
Pension plans	The past five years profit and loss accounts
Profit-sharing plans	Any buy-and-sell agreements
Stock bonus plans	Other pertinent contracts
Deferred compensation agreements, etc.	

Your Objectives

As much information as can be developed initially should be noted here.

Data Regarding the Spouse or Significant Other Person

Data similar to the above but separately applying to a spouse, a significant other person, expected beneficiaries, and their financial status are essential.

*Adapted from René A. Wormser, ed., *The Planning and Administration of Estates* (New York: Practising Law Institute, 1966), pp. 307–311.

children to share in his estate even though he knows that one child has been a black sheep and a wastrel. The trust gives him a way to accomplish the generous purpose while also providing against the wastrel's spendthrift tendencies.

"Unselfishness impels so many people to create trusts that it's unbelievable. But unselfishness, or a sense of concern for one's loved ones, may motivate persons at any age. This is particularly true where an illness or disability, affecting either the individual himself or someone to whom he is close, strikes and leaves marks."

ILLNESS

Numerous cases illustrate how illness may indicate a need for a trust. Two are given here as examples.

A wealthy woman died childless and left her entire estate to her husband. She had not been dead four months when the husband became seriously ill.

The husband had no will. Nor had he established a trust. But at the age of 64, lying in his hospital bed, he decided that he wanted to direct disposition of his wife's estate. With professional aid from his attorney, he drew up a trust agreement that specified in detail how the estate was to be managed and distributed. The trust agreement was long because the man wanted to cover all contingencies.

When the husband died six years later, at the age of 70, his estate had been put in order. Under a charitable remainder trust, the three closest nieces and nephews were provided for, the educations of five minor children were ensured, and a worthy charity had been named to receive the remainder.

The alternative? The husband's estate would have been divided among a number of nonresident nephews and nieces for whom neither the wife nor the husband had cared while alive.

In another actual case, a farmer in his forties purchased a tract of land adjacent to his farm. He took title in the name of himself and his wife as tenants in common. Each then held one-half of the title without right of survivorship—the survivor would *not* receive full title on the other's death.

The wife had had four children by a previous marriage. Late in life the farmer became ill. By then a widower, he considered the possibility of selling the land to raise funds to pay his doctor bills, but the four children would not agree to a sale.

The farmer died leaving neither will nor trust arrangement. His final days were scarred by worry and fear of the future. He could have eased his problems considerably if (1) he had taken title to the tract of land either in his own name or as a joint tenant with his wife *with* right of survivorship; (2) he had made out a comprehensive will; or, perhaps most appropriately, (3) he had created a trust and made certain that through it he would be cared for in his declining years.

PHYSICAL DEPENDENCY

The case cited in Chapter 1 of the elderly man who had to move in with a daughter exemplifies what has been termed the most common life occurrence necessitating a trust. Old age changes a person's life, arriving stealthily and gradually forcing an awareness of physical dependency; or a shock suddenly produces the same realization. The shock may be age related, or it may follow an illness or accident. The result—physical dependency—is always a major problem.

Physical dependency, of course, can take many forms. It can become a reality in anyone's life, at any age. The child who undergoes a brain operation may become as physically dependent for life as the aged woman who is confined to a wheelchair. The girl injured in an automobile accident may be as physically dependent afterward as the boy stricken with polio or the middle-aged woman injured in a fall in her home.

The physical dependency that may suggest the need for a trust may be your own or it may burden the life of a person for whom you are responsible. Thousands of trusts are brought into being so that a person can provide before death for the needs of another who will probably outlive him or her.

Angela Brown, single, expected to come into possession of more than \$150,000 in lump-sum (not installment) payment of profit-sharing funds from the company for which she had worked for 22 years. In addition, Angela owned a condominium that she had once leased as an apartment. She also had a nest egg in the bank, a few stocks. While well-off financially, Angela worried about her mother, who still resided in the small town in Iowa where she had been born.

Angela's mother had undergone a leg operation. Afterward,

bothered by arthritis that complicated the healing process, she got around with the aid of a walker. Her sister lived with her, and the two managed well. But Angela knew her mother could not survive alone if the sister were to die—and the sister was 78.

Angela chose an *inter vivos* trust as the best means of providing for her own golden years, her mother's increasing dependency, and the educations of two very young nieces, children of her only brother. The profit-sharing payout went into the trust fund on Angela's retirement.

FORGETFULNESS AND OTHER MENTAL PROBLEMS

Forgetfulness, actual senility, problems associated with deafness, and many other psychological handicaps may lead to dependency of one kind or another. So may grief, alienation resulting from a forced change of residence, business reverses, and a vast range of other challenges and life accidents.

The true story of Philip Alford may be typical. Philip had run a successful business of his own for years, handling mergers, corporate takeovers, and investments. He had extensive knowledge in all these areas and also handled his own investments.

Philip remained active in business until he was past 70. Then, by degrees, he found himself slipping. He had always run his own money errands; he had done his banking, for example, for so many years that he believed the process was second nature. But one day he found checks dating back three months on the dresser in his bedroom. The envelopes enclosing some of the checks had not been opened.

Philip decided to create a trust. At once, he had the management assistance he needed. He remained active in his business for several more years. Whenever he needed to, he could examine his books, which were kept precisely up to date by the corporate trustee, a bank trust department. At the same time, Philip retained control over all decisions relating to his considerable estate.

Philip saw signs of a mental decline that convinced him he should create a trust. In many other such cases, a spiritual element drives people in the same direction.

"As part of the maturational process the individual seems to see himself increasingly in relation to his Maker and the eternal verities," a lawyer and trust expert said. "This can occur at any age.

“Most people don’t deal with such concerns in terms of their eventual deaths, but rather with an awareness that this is part of the life cycle. Viewing that part of the cycle that lies behind them, they simply come to grips with the fact that they may become dependent and will eventually die.”

THE COMPLEX ESTATE

Assistance with the management and administration of an estate was noted earlier as a valid reason for creating a trust. The estate that has become so complex that its owner can no longer manage it comfortably alone magnifies the need for the aid that can be obtained by creating of a trust.

SIZE MAY MEAN COMPLEXITY

The complexity of the estate has often, but not always, to do with its size. A \$2 million estate will in all likelihood be more complex than an estate one-quarter that size.

If you are typical, you probably do not know how complex your estate is. It *seems* simple: So much equity value in your mortgaged home, so much in life insurance, so much in savings and stocks and bonds, so much due someday in retirement funds.

Want a professional’s advice?

Inventory it. And inventory it carefully so that you know not only what its approximate worth is but also what charges and expenses might be levied against it in the event of your death.

Once you know what you have and its current value, you can make more intelligent judgments regarding wills, trusts, and estate planning in general. If you have an estate of some size, you may see new needs arising out of unsuspected complexity or hitherto neglected opportunities.

It should be stressed that the large estate does not automatically create a need for professional management aid. It may be as simple to administer 100,000 shares of IBM stock as it is to administer 1 share, but large dollars may indicate large tax problems at some time in the history of your estate. Many steps—most of them relatively simple—can be taken to minimize the confiscatory aspects of federal and state taxation.

Most such steps can be incorporated into a well-drawn trust

agreement. An insurance policy might provide for payment of those taxes that cannot be avoided. Liquidity at a particular moment in time—perhaps at your death—may thus be guaranteed. In other cases the purchase of “flower bonds”—U.S. government securities paying less than 5 percent interest—may become advisable. These bonds are acceptable at par, or face, value in payment of federal estate taxes in the event of your death.

This is how one trustee utilized that advantage.

Joanna had a trust estate totaling more than \$700,000. In good health most of her life, she began to decline rapidly after reaching her eightieth birthday. Her trustee, a bank trust department, decided in August to invest in flower bonds with a par value of \$175,000. Because they were purchased at a discount, the bonds cost \$140,000. Joanna died in September. The bonds were then used at par value to pay part of the federal estate taxes. Thus, in one month, the bonds had earned \$35,000.

COMPLEXITY WITHOUT SIZE

“I sometimes think there’s no such thing as a simple estate,” a veteran administrator said. “At other times, I know I’m wrong.

“One client worked for an oil company. This woman left a trust estate that was both large and very simple. Over the years, she had invested in oil stocks in large concentrations. She had no more than 10 or 15 different securities. Her obligations were paid up to date. Simpleville.

“In other cases, we’ve encountered such tangled webs of real estate liabilities and interests, business involvements, and similar complications that relatively small estates cost us, really, unconscionable amounts of time. We have no choice but to carry out our trustee’s duties.”

A truism might be stated here: Whatever the size of your estate, if it is complex, it can cost you in terms of time. As a potential trustor, you have essentially two questions to ask yourself in this regard:

“What do I want to do in the area of estate management?”

“How much *can* I do in that department?”

What occurs in cases of intestacy? Too often, endless and unnecessary complexity.

A husband and wife died in an auto accident, leaving no will and

no trust instrument. They were survived by two minor children. Their combined estates were valued at about \$350,000, more than enough to support the children. But the estate of the couple went up for grabs. An intrafamily dispute developed into a bitter quarrel. Court guardianships were ordered, penalizing the children because of their excessive costs. In a short time, it became obvious that a will placing the estates in trust for the children could have been combined with a custody contract for the children.

To die intestate is to risk many other unfortunate consequences. For example, if you die without a will, the laws of your state control the disposition of your estate. In most states, neither securities nor real estate can be sold without a court order where minors are concerned. Often, substantial expense will be incurred in obtaining such an order. Perhaps worse, the laws of your state might specify how your property is to be divided. That division will rarely take place as you would have wished.

The case of Marian Krider illustrates how even a relatively modest estate can be complex. A career woman, Marian entertained one ambition through most of her adult years: She wanted to retire in the Bahamas. She died shortly after retirement, leaving a cash estate of less than \$50,000 and a prize piece of seaside property in the Bahamas.

Marian had drawn up a trust document under which a niece and nephew were the beneficiaries. When the seashore property was put up for sale, Bahamians with funds to purchase the property could not be found. Since Americans were not allowed by local law to develop the property, it languished for more than six years until a qualified and interested Bahamian buyer finally showed up. The corporate trustee had the patience and know-how required to pursue the problem to its solution.

THE INSTANT ESTATE

The "instant estate" that comes into being upon your death has already been discussed in several contexts. For instance, the insurance trust involves such a contingency. It is very fundamental in estate planning that you consider all such sudden increments to your overall worth. Pour-over and other types of trusts provide for disposition of unexpected or uncounted assets after your death.

What about the instant estate that comes into being while you are still alive and well?

What if you have assets worth \$110,000 and your Uncle Peter dies leaving you an additional \$90,000?

What if you sell your house at the undreamed of price of \$125,000 and suddenly have a *cash* estate of \$140,000?

What if the former teacher whom you've been visiting faithfully for 24 years divides her estate in half while alive and confers it on you as a gift?

A general rule applies in all such cases. Any financially momentous event in your life—or any expected event of that kind—should cause you to consider revising your estate plan. This is particularly true where the instant estate is substantial.

THE SPECIAL POSTMORTEM PURPOSE

Many postmortem purposes regarding estates have been enumerated. Dozens of others could be imagined.

You want to establish a scholarship for orphans graduating from *La Creche*? A fund for Vietnamese war babies? A secret support fund for a childhood sweetheart with whom you've had a relationship for 37 years?

You want your bottle collection to go to your granddaughter? Your classic Rolls-Royce to end up in your neighbor-mechanic's garage? Your antique table-and-chair to grace the dining room of a sister who owns a house in Seattle?

Like a will, a trust may contain any such dispositive clause. But where postdeath disposition is concerned, the trust has far greater potential. In a single document, you can, for example:

- Take care of your surviving spouse.
- Provide for a minor child.
- Save on estate and inheritance taxes.
- Avoid probate.
- Leave a remainder to a favorite charity.
- Obtain professional estate management.
- Secure all the privacy you want.
- Ensure estate continuity.

Which provisions you include in your trust will depend on your

intentions and the size of your estate. In the case of Jarvis Jennings, possessor of a \$1 million estate, the education of 17 grandchildren appeared to be paramount. Yet Jennings did not want his own four children to feel left out. A “five-in-one” trust was created. Of the five equal parts into which Jennings’s estate was to be divided at his death, four parts went to the children. The fifth constituted a separate trust fund from which the costs of educating the 17 grandchildren were to be taken. The solution proved again the immense flexibility of the trust as a legal device.

WHAT ESTATE JUSTIFIES A TRUST

Just as no ultimate formula has been devised to define *standard of living*, none exists to help you decide whether your estate justifies a will or trust. Many lawyers, trust officers, and other professionals would counsel that anyone who earns money has at least a potential estate—and an estate, potential or actual, requires planning.

Significantly, banks and other institutions that act as trustees have increasingly tailored their services to the middle-class market. A leading New York bank that once concentrated on trust services for people with estates of \$250,000 and up recently announced that it will assist those with estate of \$50,000 and up.

The new dispensation suggests a basic change in approach. The professional corporate trustee is gearing itself more and more to the trust as a means of planning the future disposition of almost any estate. Whether that will affect you depends on your plans, needs, responsibilities, expectations, and present worth.

The last point brings up some concrete considerations. Beginning in 1981, an estate with a total valuation of more than \$175,625 will be taxable under federal law. That means, if avoiding unnecessary taxation is important to you, you may want to consider a trust if your estate is greater than that amount.

COSTS OF THE TRUST

Other realities should influence you as you approach the possible choices and decisions. For example, the costs of trust creation and administration should be duly noted. These costs may make trusts, over the long term, more expensive than probate. For one reason, these costs go on year in and year out. Also, they are

charged as fees, and extra services delivered in connection with a trust estate will mean additional charges.

The charges levied against a trust estate are also gauged to the size of the estate. Where a larger estate is concerned, such charges need not be of great concern. In the case of a smaller estate, the fees can become important. A senile spouse who survives his or her mate by many years while living in a retirement home or rehabilitation center may exhaust all the available trust funds. The trustee paying out \$1,000–\$2,000 or more per month for the spouse's support and medical care may then face the gut-wrenching task of collecting corporate fees from a trust corpus that has all but disappeared.

More on the costs of trusts appears in Chapter 10, but it should be noted here that even the process of creating a trust involves expenses. If an attorney is used, the legal fees required for the draft of the trust instrument can be substantial. Hours may be consumed in investigative efforts or in clarification of the trustor's purposes—at \$50 or more per hour.

INSTITUTIONAL PRACTICES

Cost factors assume unusual importance where a trustor is considering a professional corporate trustee. The costs, the size of the estate, and the institution's practices become elements in an equation whose solution may depend more on common sense and deeper feelings than on arithmetic. One trustor may feel that the professional trustee's know-how will more than offset the potential costs. The belief that the trustee will, over time, increase the size of the estate by investing wisely may in fact be justifiable.

Another trustor may decide after examining the facts that his estate is not large enough to justify establishment of a trust. He may then seek some other solution.

A practical question relates to the specific problem of how much value, in terms of services, the trustee can deliver where smaller estates are concerned. Institutional policies and practices generally indicate a preference that all the assets of an estate be placed in trust when any part of that estate is so disposed of. The same policies and practices usually require severe limitation of services where an estate of, say, \$25,000 or \$50,000 is concerned.

As will be noted, a .5 percent annual fee is normal where a

professional trustee is administering an estate. With an estate of \$250,000, the fee would come to \$1,250.

Could wise investment policies more than balance such an annual levy?

The answer is: very likely. But under their own policies and practices, many corporate trustees discourage potential trustors with smaller estates. Some go so far as to discourage people with living estates of \$300,000 or less and expectations of after-death estates of \$500,000 or less.

You can probably find a corporate trustee that will handle a \$25,000 estate, but you will want to weigh the pros and cons carefully. Under no circumstances will the \$25,000 estate receive the same attention and service that the final estate of J. Paul Getty received.

Chapter 10

COSTS OF ESTABLISHING AND ADMINISTERING A TRUST

Institutional trust departments have long had a reputation as loss leaders. Unprofitable in themselves, they at least brought people—and presumably new business—into the bank, trust company, or other institution.

The concept is changing, if slowly. Bank managements have increasingly stressed the need to show a profit in their trust departments. At the least, operating losses that once seemed perfectly acceptable have come under close scrutiny. Where the size of the assets managed once served as the most important yardstick of a trust department's success, today the bottom line of the income statement takes precedence. Institutional trust departments have, consequently, increasingly used direct selling techniques in their efforts to attract trust and estate business.

Just as significantly, trust officers have been asking themselves harsh questions. Under pressure to produce profit, they have tried to analyze such issues as:

- How much profit a given asset base will generate for the trust department—and over what period of time.
- When, or in what year, that asset base and corresponding fees will be reflected in the income statement.
- What type of new business should be pursued, and how.

- Whether estates represent a more profitable kind of business than trusts.

Such facts point up a fundamental reality facing any potential trustor: Trust departments provide a range of services and make available a variety of skills and expertise for which they *must* charge. The fees taken in combination with the taxes that are levied against trust estates represent substantial overall charges. Those charges come out of the trust income or corpus. They are the corporate trustee's means of making a livelihood, of ensuring that the bottom line has a healthy look.

Taxes and the fees charged by corporate fiduciaries have to be considered separately. While fees will vary widely depending on the trustee's location—whether in a large city or a small town, for example—federal taxes are levied according to uniform rules and regulations. State taxes reveal virtually no pattern; some states, like Florida, allege that they have no estate, inheritance, or other death taxes while collecting similar levies under other names. Other states openly assess trust estates according to their own established formulas.

TAXES AS AN ADMINISTRATIVE COST

The establishment of a trust in effect creates a new taxpayer: the trust. The trustee assumes the responsibility for filing tax returns, paying the taxes, and performing related duties. The trustee does not act as an agent in carrying out these functions; he is the fiduciary taxpayer.

The tax functions of a trustee can be onerous. They require time and care, as do all tax duties. In addition, in some cases the trustee may be personally liable for the taxes. The taxes paid by trustees fall into three general categories: income, gift, and estate/inheritance taxes. Gift taxes are discussed in Chapter 12; the other two are discussed below.

INCOME TAXES

The fiduciary is required to prepare and file the fiduciary income tax returns using Form 1041, the United States Fiduciary Tax Return. Tax returns required by state and local authorities have to

be filed as well. Timely filing is important; unless returns are filed on time, valuable options may be sacrificed. Where penalties are specified, the trustee may become liable for surcharges unless the proper filing regulations are observed.

The choices of fiscal year and method of accounting may also affect the trust's tax picture. They may, for example, help significantly in determining the total tax impact on the ultimate beneficiaries. It should also be noted that a relationship exists between the amount of income taxed to a beneficiary and the amount for which the trust is taxed. Income that is distributed and taxed to the beneficiary represents a deduction for the trust. Thus, prior planning makes reductions in the trust's total tax bill possible.

Whether the trust is inter vivos or testamentary, the trustee is required to file an income tax return form (Form 1041) for any year in which the trust had a taxable income of \$600 or more. The general principles that define an individual's income apply equally to the trust.

Overlapping tax years. A case illustrates how trustees can take advantage of tax deferral privileges created by thoughtful assignment of tax-year dates. Securities in a decedent's estate were to be paid over a two-year period into three trusts established for the decedent's children. The *estate* tax year selected by the executor began on May 31 and ended on May 30 the following year—the legally specified 12 months. The *trust* tax year began on April 1 and ended on March 31 the next year; the trustee for the three trusts made the choice of these dates.

The tax years overlapped from April 1 to May 30, 1979. The executor of the estate made equal distributions of securities to each trust during this period. The individual trusts would be taxed on the income earned by the estate—in this case \$60,000. The trusts at the same time were funded through distribution of some of the securities. By then these were taxable at a substantially higher rate than at the decedent's death because of market fluctuations. The trustee at once paid out to the three beneficiaries the \$60,000 income on the securities during the overlap period.

The trustee in the above example was using the following principle to defer the beneficiaries' tax liabilities: A beneficiary is held to have received trust income in the year in which the fiscal year of the trust ends. That meant that the beneficiaries, receiving

trust distributions in May 1981, did not have to report these distributions until they made out their 1982 income tax returns.

The trusts reaped a prior deferral advantage. They received shares of stock that carried with them the income tax consequences of the income earned during the first year of the estate. Ordinarily, the trusts would have had to pay taxes on this income *and* on the securities, at the fair market value of the latter at the time of distribution. But the trusts did not have to pay taxes at once on this increased value. Instead, the trusts, receiving distributions in May 1979, when the trust year was already under way, did not have to report the distributions until their 1980 tax year. (See Exhibit 6 for a case in which an alternate valuation was *not* adopted.)

The trusts reported the distributions in 1980, the beneficiaries in 1981.

Estimated tax, withholding, and information returns. A trustee need not file estimated income tax returns, but withholding reports on income tax and Social Security are required of trusts that are employers. As in the cases of persons and other legal entities, a

Exhibit 6. Examples showing optional valuations on decedent's real estate.

Example where the alternate valuation is not adopted: Date of death, January 1, 1955		
Item No.	Description	Value at Date of Death
1	House and lot, 1921 William Street NW, Washington, D.C. (lot 6, square 481). Rent of \$900 due at end of each quarter; February 1, May 1, August 1, and November 1. Value based on appraisal, copy of which is attached	\$36,000
	Rent due on item 1 for quarter ending November 1, 1954, but not collected at date of death	900
	Rent accrued on item 1 for November and December 1954	600
2	House and lot, 304 Jefferson Street, Alexandria, Va. (lot 18, square 40). Rent of \$100 payable monthly. Value based on appraisal, copy of which is attached	12,000
	Rent due on item 2 for December 1954, but not collected at date of death	100

Example where the alternate valuation is adopted:
Date of death, January 1, 1955

<i>Item No.</i>	<i>Description</i>	<i>Subsequent Valuation Date</i>	<i>Alternate Value</i>	<i>Value at Date of Death</i>
1	House and lot, 1921 William Street NW, Washington, D.C. (lot 6, square 481). Rent of \$900 due at end of each quarter: February 1, May 1, August 1, and November 1. Value based on appraisal, copy of which is attached. Not disposed of within year following death	1/1/56	\$30,000	\$36,000
	Rent due on item 1 for quarter ending November 1, 1954, but not collected until February 1, 1955	2/1/55	900	900
	Rent accrued on item 1 for November and December 1954, collected on February 1, 1955	2/1/55	600	600
2	House and lot, 304 Jefferson Street, Alexandria, Va. (lot 18, square 40). Rent of \$100 payable monthly. Value based on appraisal, copy of which is attached. Property exchanged for farm on December 1, 1955	12/1/55	10,000	12,000
	Rent due on item 2 for December 1954, but not collected until February 1, 1955	2/1/55	100	100

Source: J. G. Denhardt, Jr., *Complete Guide to Estate Accounting and Taxes* (Englewood Cliffs, N.J.: Prentice-Hall, 1964), p. 139.

trustee has to file at least information returns when paying \$600 or more in income in any given calendar year. The fiduciary must, in fact, report payments made to both a decedent and the estate when reconstructing the decedent's tax return. Payments to beneficiaries are not included; with these, the fiduciary tax return serves as an information return.

Income tax rates. As a general rule, the trust falls approximately in the income tax bracket that a married taxpayer filing separately would occupy. That means that the trust will file a return that is approximately 40 percent higher than that of the married taxpayer filing jointly on the same income dollars.

No intrinsic, consistent reason has been cited to justify the difference. "Tax law has never, necessarily, been logical and consistent," the head of a corporate trust department noted. "The married taxpayer filing separately may even have a better break than the trust insofar as income tax is concerned. He or she may be able to write off certain expenses that a trust cannot deduct."

To some extent, income taxes fluctuate quickly and almost unexplainably. With an income of \$10,000, a trust falls in the 32 percent bracket. But the trust is allowed to deduct directly from income such charges as attorney's fees, trustee's fees, and accounting fees. On the other hand, even small capital gains in an estate with little income are heavily taxed. Since the trust can deduct income distributed to a beneficiary, the trust may in some cases end up with capital gains as its only taxable funds.

Form 1041 is a relatively simple form, complete on two sides of a single page. It must be filed annually and requires that the trustee account for both long- and short-term capital gains and losses. Capital gains deductions must be computed, as must capital loss limitations. The form also allows for an alternative tax computation where a net long-term capital gain was realized, or an excess of net long-term gain over net short-term capital loss, in an amount more than \$26,000.

Trapping income. "Trapping losses" becomes a device of great value under certain circumstances. In a trust with various forms of property, for instance, where these entities have come into being as a result of a death, tax payments can be delayed, or they can be taxed at a propitious moment. The choice lies with the trustee.

An example shows how trapping works. Jake Albert died, leaving an estate that would shortly receive a \$76,000 employment

bonus from Jake's employer. Jake's wife was to act as his trustee. Within two weeks after Jake's death, the bonus payment arrived. It was duly credited to Jake's trust estate; when his wife made out the estate income tax forms early the following year, ten months after Jake had died, she reported the \$76,000 increment and paid taxes on it as part of Jake's overall estate.

Because Jake's death precipitated a change of identities, from Jake to his trust estate, a trustee for Jake's estate might have chosen an alternative reporting modality. He could, legally and logically, have specified that the tax year would run for only two weeks after Jake's death.

Jake had died on February 1, 1979. The trustee could have elected to have the tax year, for the purpose of reporting the bonus payment, end on February 14. The bonus would have been "trapped" in that artificial, yet completely allowable, tax year. The taxes for that short "year" would have been proportionately much lower than if the bonus had been included in the overall estate. Thousands of dollars in taxes would have been saved.

The next tax year, insofar as Jake's estate was concerned, would have begun on February 15, 1979 and ended on February 14, 1980. The trust income earned during that year could have been distributed to Jake's wife during that period. It would then have been reportable in the returns the wife had to file by April 15, 1981. She does not, in other words, realize the trust income until the year in which the trust year terminates—in this case 1980—and that income need not be reported until the following year.

The trust might have gone further. It might have made a distribution of the \$76,000, or of part of it, so that it could have been taxed to Jake's wife in yet another year.

Overall, the strategy involves trapping a sizable income item in a tax "year" in which little other income was received. Aside from the tax savings, tax deferral would be achieved for Jake's widow.

Because of such options, trust officers normally analyze the situation of a trust estate shortly after the trustor dies. Key factors that come under consideration are the estate's liquidity, the number and amounts of debts, charges and fees that must be paid, and the possibility that a different-from-normal tax year should be selected. Such analysis may take place repetitively over a period of months, until all assets, debts, and other aspects of the estate have

been accounted for. As one result, most trust estates have abnormal tax years.

Private executors and trustees have, of course, the same options.

ESTATE AND INHERITANCE TAXES

Estate taxes are levied according to the same schedules as gift taxes (see Chapter 12): When an individual dies, the estate is required to pay from 18 to 70 percent in taxes to the federal government. The maximum 70 percent tax rate goes into effect when the estate is valued at \$5 million or more.

The trust estate generally includes everything owned by the decedent. "That means both real and personal property," a tax expert noted. "It includes whatever the decedent owned or had a right to dispose of . . . cash, the stamp collection, the Samurai sword he brought back from Japan at the end of World War II, the family silverware, the decedent's car, the furniture in the home, the fishing rod—everything."

The trustee can deduct from the trust corpus all the decedent's debts and all charges and fees for which he would have been responsible. The mortgage on the decedent's house is deductible, as are any monies he owed to his own children and any proven income tax liabilities. A modest deduction may generally be claimed for state inheritance taxes. Still other deductions include the expenses of trust administration and any funds set aside for charity.

Trustee expertise in tax matters can pay handsome dividends in the form of tax savings. The trustee, for example, will want to account for "double deductions" such as business and nonbusiness expenses, interest, and taxes incurred by the decedent before death. These may be deducted on both the estate tax return and the fiduciary income tax return. The trustee will also have options, as indicated. In some cases, deductions may more appropriately be made on the decedent's estate tax return; in other instances, it is wiser to make them on the decedent's income tax return.

What thinking influences the decision to assign deductions to either the federal estate tax return or the fiduciary income tax return?

Judy Bertram died, leaving an estate of \$700,000. A charitable remainder trust accounted for nearly one-third of the estate, re-

ducing federal estate taxes. But substantial income taxes would have to be paid during the lifetime of an income beneficiary.

The trustee decided to deduct the administration expenses, nearly \$30,000, from current income. Reporting was done on the estate tax return (Form 706) rather than on the federal income tax return (Form 1041). As a result, federal estate taxes and income taxes were each paid at less than 35 percent. Without the deduction, income taxes would have taken nearly 50 percent of the estate's income.

A comparison of the income tax and federal estate tax rates is revealing. An estate valued at \$150,000 will pay only about \$3,800 in federal estate taxes. The next dollar would be taxed at the rate of 32 percent, the marginal rate. By contrast, income totaling only \$10,000 would involve a tax liability of \$2,190. The marginal rate would again be 32 percent.

State inheritance taxes, which are levied against the heirs to an estate, vary widely from one state to the next. The trustee will pay these taxes according to a system established within the particular trust department at the rates specified by the law of the state in which the trustee operates.

ADMINISTRATION AND OTHER FEES

The trustee will have options also with regard to attorney's and accountant's fees, administrative expenses, and other items. In looking at the tax effects of his ultimate choice, the trustee goes beyond the rate tables and thinks in terms of effective rates. In a widow's trust, for example, where a marital deduction is sought, an administrative expense deducted from the estate tax will record an effective saving that is approximately one-half the estate tax rate. The trustee considers the effects his choices will have on the beneficial interests. A particular choice may prejudice the interests of one beneficiary in favor of those of another.

Various other fees must be charged to the estate. Usually, they are paid out of principal and thus reduce the size of the residuary estate. But they may be charged partly to principal and partly to income, or entirely to income, depending on the laws of the particular state.

The usual fees include annual, minimum, withdrawal, termina-

tion, and legal fees. Some special fees, such as real estate management fees, may also be charged.

ANNUAL FEES

Laws and practices affecting the annual fees charged by corporate trustees vary widely. In some states, laws govern all trustee fees, establishing specific rates. In other states, annual fees vary from town to city and from institution to institution.

Generally speaking, annual fees are charged as percentages of trust assets. A typical fee would be .5 percent of the trust corpus. In other cases, the corporate trustee may charge a higher percentage but will gauge the charge to the amount of income the trust earns.

Suppose you have \$100,000 in trust, which earns 7 percent, or \$7,000, in annual income—not an extraordinary rate in today's context. Out of that income, you are paying .5 percent of the corpus, or \$500, as the annual fee. That means you are paying an annual fee that runs slightly higher than 7 percent of income per year. If you were paying \$1,000 as an annual fee, that payment would represent somewhat more than 14 percent of the annual income.

In another case, you decide to establish an *inter vivos* trust with \$50,000, the minimum acceptable at many institutions. You use the Opportunity Trust offered by your bank. This packaged trust includes a number of specified services. At least in theory, these services give you most or all of the advantages of the living trust, while eliminating a broad range of custom features, and your fee is around \$200 per year.

While opinions differ regarding the utility value of packaged trusts, you may well be getting your money's worth with the Opportunity Trust—and you know exactly what you are buying.

MINIMUM FEES

Aside from regular annual fees, many corporate fiduciaries have a minimum fee. Where small trusts are involved, the minimum fee will be charged regardless of the amount of the trust corpus. The minimum will probably be \$500–\$1,000 per year.

A minimum fee is generally justified on the ground that administration of a small trust may be as onerous and time consuming as

administration of a larger trust. Trust officers also maintain that their institutions offer services that would require substantial investments of time if performed by the trustor himself or by a private trustee. Outlays of cash for special assistance or special services might also be required.

It may be fact that "your trustee doesn't do any more than you can do," but it is also fact that your corporate trustee brings to the fiduciary's job professional knowledge and techniques that are difficult to find outside a trust department.

WITHDRAWAL AND TERMINATION FEES

The withdrawal fee is charged when you take funds or property out of your trust estate or move the trust to another institution. The typical fee is 1 percent or less of the trust corpus, not of the amount withdrawn.

A withdrawal fee would also be charged when a trustor changes his mind after setting up a trust and voluntarily withdraws part of the corpus from the trust. But under certain circumstances, no withdrawal fee would be charged. A portion of a trust corpus might be withdrawn in a case where a bank trust department is serving as trustee. If the withdrawn portion remains in the bank—for example, in a savings account—the bank would probably not charge a withdrawal fee.

Another trustor might cash trust securities to cover expenses in an emergency. The corporate trustee might then charge a minimal withdrawal fee, perhaps .5 percent.

The termination fee, also 1 percent or less in the normal case, is charged when the trust is terminated for any reason. That can occur when the trust corpus is finally exhausted. It can also take place when a particular event occurs, as specified in the trust instrument:

- When the trustor or another person dies.
- When son Joseph reaches his twenty-first birthday.
- When the youngest of Arthur's five children receives his doctorate in economics.
- When Aunt Mame's young lover marries.
- When the family home is finally sold and turned into liquid cash that makes the trust estate easily distributable.

LEGAL AND OTHER SPECIAL FEES

Situations requiring legal or other professional services may arise from time to time. But because most corporate trust departments have a range of services already available, the special situations are relatively rare. In most cases, too, the trustee will seek to obtain the permission of either the trustor, if alive, or the beneficiary before contracting for such professional services.

Other special fees have become the subject of extensive study. Some experts have maintained that the entire process of charging for special trust services should be computerized. Computerization may be undertaken within the institution or handled outside it on a purchased-time basis. A typical remote batch accounting system for trust departments offers completely computerized accounting services that make internal computer systems unnecessary.

More commonly today, trust departments charge for special services that they themselves provide on an hourly basis. A rate of \$30-\$60 or more an hour would not be considered unusual; \$45-\$50 would be typical. In rural communities, corporate fiduciaries might charge no fees at all for special services for important patrons. In major banking institutions, the charges could be on the high side of \$60 per hour.

Because many consumers want to know exactly what they will receive in return for the fees they pay, corporate fiduciaries tend today to "unbundle" their fee schedules. That means they specify what each basic type of service will cost rather than state fees as a single catchall figure. Statements of account will cost \$80 or \$90, for example, and can be issued as often as the trust client wants to pay that price. Checks will be charged at the rate of \$4 or \$5 each, and again can be prepared and issued as often as required.

Real estate management fees. The difficulties involved in establishing special service fees where real estate management is concerned have been heavily debated. Who can really place a value on intelligently drafted policies that increase the value of real estate or that make real estate productive where once it represented no more than a tax burden?

Such considerations have in many cases made real estate management fees under trust arrangements the subject of negotiation. No definitive guidelines on such fees exist, yet authorities on trusts maintain that cash flow provides an acceptable yardstick. An 8

percent annual fee on the cash flow has been held up as a viable maximum: If the cash flow totals \$50,000 from rents and other sources of real estate income, a fee of \$4,000 would be charged annually.

More typically, fees of 3–6 percent have been charged where personal trusts are involved, but that figure—again in the opinions of experts—does not contain the incentive needed for thoughtful, flexible management. Such management may not only ensure a high degree of professionalization in the manager's function; it may also result in a major increase in the value of the real property.

Expertise needed. Few would deny that skillful management is absolutely essential where real estate holdings are concerned. The real estate manager has to consider local, national, and international factors if he is to obtain investment profit and, ideally, appreciation in value. Interest rates, taxes, market and economic conditions, zoning laws and regulations, and property, financial, and other facts have obvious impact on real estate.

Even energy plays a basic role in real estate matters. In an era of energy conservation, the location of real estate in relation to major city centers and modes of public transportation can become crucial. The costs of various types of fuel can have major impact on the profitability of income property.

Public trusts, pension funds, and other public entities have long recognized the importance of professional real estate management. Most such public entities pay management fees based on a percentage of asset value. Whether that kind of formula would work where personal or private trusts are concerned remains a question for the trustee to decide. The formula would certainly raise the fees charged for real estate management services. Higher fees might consequently reduce the flow of business to the trust department, a consummation to be avoided.

FEES VERSUS SAVINGS AND SERVICES

In all, without incurring any real estate management or other special fees, you may pay .8–1 percent in administration fees to your corporate trustee.

Is it worth it?

That, obviously, depends on your situation. In establishing fees,

trustees are simply placing a value on their services and knowledge. Those services can be numerous; the knowledge is nearly always considerable.

Think of some of the possibilities. Have you a ranch, a farm, an apartment complex, or a factory that needs professional management? Any one of those enterprises might be a full-time job for you. Would you balk at passing the overseer's responsibilities to a professional fiduciary?

Have you reached a "rocking-chair" stage of life? Do you want to shed chores and responsibilities and settle down to ruminate alongside your own Walden Pond? Do you want to bicycle across Mexico?

If he enables you to fulfill any of those ambitions, a trustee might be worth almost any fee. But remember, his services are geared for use at any age, by either sex, and under nearly all circumstances. The real question you have to ask is: "Am I getting my money's worth?"

Corporate trustees make a final point that relates directly to the issue of fees versus savings and services. As one noted, "We believe we can invest better than the individual can. Your annual trust fee may be \$600. But where you would reap an investment income of, say, \$5,000 a year, we may be able to bring in \$7,000 annually. That makes the annual fee of \$600 worth it—and more."

You will want to know in advance the fees involved in establishing and maintaining a trust, and you will need to investigate exactly what you will be receiving for your money. Then you will have to answer for yourself the question, "Can I afford it?"

Chapter 11

TRUSTEES AND BENEFICIARIES: RIGHTS AND DUTIES

The tasks of selecting a trustee places a massive responsibility on your shoulders. Whether individual or corporate entity, the trustee will probably make or break your trust arrangement. The reason has been noted: The trustee stands in a crucial fiduciary relationship to you and your beneficiaries.

That relationship controls the trust. The trustee must obviously have integrity and also a genuine understanding and concern for the welfare of your beneficiaries. The trustee's actions are regulated by law, but the manner in which the trustee performs his duties can make the difference between a trust's success and its failure.

A trustee should generally have other characteristics. These include:

- At least some experience that qualifies him to act as trustee. Experience with life or business may in some cases be adequate. In other situations, a trustor looks for a degree or range of experience that ensures that the trust plan will not be frustrated by neglect or incompetence.

- Responsibility. Acting responsibly, the trustee will do his best to carry out the terms of the trust agreement.

- Availability and willingness to serve as trustee. Lacking either characteristic, he should probably not be named to a trusteeship. If his business or profession keeps him traveling constantly, he will probably not have the time to serve as trustee. Other problems may likewise render him ineligible to perform the services and make the

personal and professional contacts that are required. If a potential trustee represents himself as being unwilling to act in that capacity, he should not be considered.

The qualifications established for a trustee-to-be suggest some guidelines you can use in making a selection. The duties that a trustee undertakes to discharge and the powers that he is granted indicate perhaps better than any other factor why your selection should be given serious thought.

As holder of the equitable title to the trust property, the beneficiary has certain rights. He may also, as will be seen, have some duties and even liabilities.

DUTIES AND POWERS OF THE TRUSTEE

The duties of the trustee have been said to begin where an executor's leave off. The trustee under the typical trust agreement has legal title and must act in the interest of the beneficiary or beneficiaries in managing or otherwise taking action with regard to the property.

The powers of the trustee arise out of the terms of the trust agreement for the most part. Some powers, however, may be either optional or presumed.

GENERAL DUTIES

Some of the trustee's duties have been indicated. The trustee must, for example, act uniformly with loyalty toward the trust agreement and the beneficiary and carry out the terms of the trust to the best of his ability. He has the duty to preserve the trust property and make it productive within the limits of the powers given him.

In discharging his duties under the trust agreement, the trustee acts, in a sense, on his own as holder of the legal title. He is personally bound by and liable for his actions. His duties, powers, and liabilities under the trust instrument come under the watchful jurisdiction of the equity court. The terms of the trust instrument control him unless they run against public policy or show inconsistencies with the law. In greater detail, the general duties may be described as follows.

Loyalty to the trust property. "The morals of the marketplace"

GUIDELINES FOR TRUSTEES MAKING INVESTMENTS

Some widely accepted guidelines are used by trustees in making trust investments. Specific guidelines refer to stocks, bonds, and other types of investments. For example, trustees usually apply certain standards when investing in marketable securities and different standards when buying nonmarketable securities. The *general* guidelines include:

1. The marketability or liquidity of a specific investment.
 2. The maturity, call, or redemption date of a given investment.
 3. The probable duration of the trust.
 4. The probable condition of the market when the trust terminates, insofar as that might affect the value of the investment.
 5. The probable condition of the market, insofar as reinvestment is concerned, at the maturity date of the investment.
 6. The size of the trust corpus and the nature and extent of other investments.
 7. The beneficiaries' income requirements.
 8. The beneficiaries' other assets, including income and earning capacity.
 9. The tax effects of the particular investment.
 10. The beneficiaries' ages.
 11. Family and other circumstances or qualifications.
-

have no meaning for the trustee. His duty of loyalty to the trust property cannot be equated with simple honesty of behavior and intent. Rather, it has been described as *undivided loyalty*.

The trustee obviously sacrifices some freedom of action in assuming the trustee's duties. He cannot take profit from the use or exchange of the trust property. He cannot even derive advantage from such use. That means he cannot sell or lease trust property to himself; nor can he buy his own property for the trust. He cannot buy trust property even at his own public auction. The trustee of two trusts cannot, in essence, deal with the trust property for his own account.

One exception may be noted: The trust agreement establishing interrelated family trusts may confer on the trustees the power to deal with one another. The trust language in such cases specifies that the trustees can enter into transactions with the trustees of other trusts created by the same trustor or a member of his family. A typical provision would give the trustees the power

to deal with, purchase assets from, or make loans to, the fiduciary of any trust made by the settlor or any member of his family or a trust

or estate in which any beneficiary under this agreement has an interest, though a trustee hereunder is such fiduciary, and to retain any property so purchased.

Prohibitions do not make up the entire code under which the trustee functions. In a positive sense, he must act affirmatively to further the interests of the trust. He stands under the obligation to press all demands, even to the point where he brings suit, that seem to be required to preserve or protect the trust property. If he fails to bring such action, he may be held accountable for "careless forbearance."

Loyalty in dealings with the beneficiary. The trustee has the further duty of dealing with scrupulous fairness toward the beneficiary. In no way can he take advantage of his privileged knowledge or position. He is required to inform the beneficiary fully of the details of any particular matter.

In case of a legal dispute, the courts would make certain presumptions regarding the trustee. They would assume, for example, that the trustee had acted fraudulently if he benefited in a transaction with a beneficiary. But the trustee could act as attorney, broker, or counsel for the beneficiary in nontrust matters. The trustee would only be required to show that he did not use his trust position to secure the employment.

Duty not to delegate. Because a trust places the trustee in a position of personal confidence, the trustee cannot generally delegate his basic and overall management duties. But the trustee can delegate the performance of administrative details.

How do the courts draw a distinction between proper and improper delegation? A very fine line separates the two, and no clear-cut formula exists to guide either trustees or the courts. One thing is certain: The amount of discretion conferred on the trustee constitutes an important factor. Whether the trustee has acted prudently always stands as a fundamental question.

Can a trustee engage an investment counsel, pay for these services out of the trust fund, and follow the counsel's advice in making or terminating investments? Court decisions throw little light on the question. It has been relatively well established that a trustee cannot delegate his power to invest and reinvest. On the other hand, the trustee has been held to be acting properly when

he seeks out and pays for professional advice. A reasonable interpretation of the precedents in this area would hold that the trustee has to exercise reasonable care when selecting counsel. He must also pay a reasonable fee and act with prudence when following another's professional advice.

Duty to keep and render accounts. The trustee has to keep accounts that reveal the nature, amount, and manner of administration of the trust property.

An account . . . is the statement of receipts and payments by a trustee concerning the estate confided in his care; the detailed statement of its administration while in his hands, what has been received, and from what source, what has been paid out and for what purposes, and the balance, if any, remaining.¹

These accounts must be rendered at reasonable intervals.

In most states, specific statutes require that the trustee file an inventory of trust property soon after he assumes his duties. The inventory has special significance with regard to taxes and tax reporting. In part, the trustee's account provides the launch-point for all subsequent accounts. Submitted usually once a year, the account may be required by a court if the trustee fails to file it in any given year. Normally, accounts are required annually in any case as part of the preparations for filing income tax returns.

Many other rules apply to the account that the trustee must keep and render. For example, it should show the condition of the trust estate. It can usually take any acceptable form if it shows in detail every transaction and provides a listing of the trust properties or assets.

Duty to exercise reasonable care and skill. "Reasonable care and skill" has proved as elusive a standard as proper delegation of detailed administrative work. Using a broadly generalized rule of thumb, the courts have decided that the care and skill required are those that a prudent man of discretion and intelligence would exercise.

Reasonable care and skill are usually required where investments are concerned, but the standard applies as well where other administrative matters are involved. The terms of the trust instru-

¹Brown v. Howe, 9 Gray 84, 85 (Mass. 1857); In re Herr, 22 N.J. 276, 165 A2d 706 (1956).

ment may make this requirement either more or less stringent. For example, the terms may impose an unusually heavy obligation in some areas. In others, an exculpatory clause or permissive language may in effect relieve the trustee of strict adherence to the general rule.

A trustor can also, by including exculpatory language in a trust agreement, relieve a trustee of specific investment or other responsibilities. In one case, stock in a closely held corporation was excluded from the trustee's range of investment responsibilities.

Duty to take control and to protect the trust estate. These two duties are often listed as primary: The trustee should, it is assumed, be required to take control of the trust property at once. Then he should be obligated to protect the property.

In whatever order this specific duty is cataloged, the trustee is nevertheless responsible for immediately taking and keeping control of the trust property. If he delays, he may be held liable for any losses occurring because of his failure to move quickly. Taking control may involve many different functions, among them recording real estate and registering securities.

Protection of trust property, as a guiding rubric, suggests other prudent-man considerations. Because the trustee cannot delegate his duties, he will probably want personally to make certain that adequate insurance has been taken out to protect trust interests. Property taxes may have to be paid. Stock subscription rights may have to be exercised. If legal actions have been brought against the trust for any reason, the trustee will have to take the necessary defensive action. If the trust's interests require that a suit be brought, the task of launching such action devolves on the trustee. Where the trust estate has a claim against an individual or other entity, the trustee has the duty to press that claim. But the laws of some states allow him to compromise where a compromise appears possible.

Duty to segregate and identify trust property. The trust must be administered as an organized collection of assets. Thus segregation and identification of trust property rank as a *sine qua non* of effective administration. For purposes of simple efficiency, the trustee earmarks the trust property, identifies it, and keeps it separate from his own and all other properties with which he may be involved.

Some procedures appear to proceed naturally from this general rule. A separate and properly identified trust bank account would be a necessity. Securities would logically be deposited in a special safe-deposit vault, and the contents would be identified as trust property.

In some cases, the terms of the trust might relieve the trustee of the obligation to segregate trust property. Commingling of the assets of two or more trusts might, in other words, be permitted by explicit reference. The intent of the trustor controls in this case; the trustee must, however, retain the capacity to prove that he has productively and faithfully managed the trust fund. If commingling entails any risk, the trustee should avoid it at all costs.

Duties to the beneficiaries. The trustee has some miscellaneous duties vis-à-vis beneficiaries. The more important ones might be described as follows:

- He must treat all the beneficiaries equally. Even when exercising discretionary powers with regard, for example, to distributions of trust income, the trustee cannot prejudice one beneficiary in favor of another. He cannot, in essence, act capriciously or arbitrarily.
- He must remain open and communicative insofar as the beneficiaries are concerned. Beneficiaries must have access to accounts and records; they should be shown receipts and vouchers if they so request.
- He must collect the trust income and distribute it to the beneficiaries after making any necessary deductions and allowances. Normally, such distributions would be made in accordance with the trust terms. Income distributions are nearly always made on a regular basis and, unless the trust agreement specifies otherwise, without regard to the recipients' ability to manage or spend wisely. (Distributions of principal may be made much more cautiously because of the trustee's general obligation, specified in most trust documents, to safeguard the trust corpus.)

Under certain circumstances, trust income may be distributed with an eye to the beneficiaries' situations. In some trusts, for example, the corporate fiduciary has the power to withhold income from beneficiaries in high tax brackets when the trustor has foreseen that more income for these beneficiaries would only increase their income taxes.

POWERS: EXPRESS AND IMPLIED

In the normal case, the trustee has both express and implied powers. The former are explicitly granted by the trust instrument. The latter may be assumed to exist where they appear to be necessary or appropriate to the task of administering the trust. But usually powers not granted explicitly are not considered granted. In no case can either express or implied powers be exercised to the clear prejudice of a beneficiary, because the beneficiary's rights remain paramount to all administrative functions.

The trustee's powers vest in him once he has assumed the trustee's responsibilities. If there are two or more trustees, the powers vest in both or all of them jointly.

Except in the case of a charity with a board of trustees, where a majority of the board can act, trustees rank as joint tenants and must act collectively to make decisions, defend against lawsuits, vote on corporate stock, or take other actions of significance to the trust.

This requirement has been cited as an objection to naming more than one trustee, since it can be cumbersome to bring together even two trustees where an important decision is required. Tru-
stors can simplify the tasks of multiple trustees by specifying in the trust agreement how disagreements among the trustees are to be resolved.

Other rules regarding vesting of powers should be noted. Where there are multiple trustees, if one trustee ceases for any reason to be able to discharge his functions, the survivors take over all powers. Where there is a single trustee, if the trustee dies or becomes incapacitated, his successor assumes all the trustee's powers, whether express or implied. The powers do not have effect with regard to one act or process; rather they apply and confer the right to act over an extended period of time. If specific conditions on the duration or extent of the trustee's powers appear in the trust instrument, these provisions must be considered primary and controlling.

Under certain circumstances a power may logically—or even necessarily—be implied by the terms of the trust agreement. A trustor, for example, has a single piece of valuable real estate that forms the bulk of his estate. The terms of the trust require that the trustee divide the entire trust corpus among the beneficiaries. The

trustee would then have the implied power to sell the real estate in order to carry out the terms of the trust agreement.

He must use discretion, of course. A rule of reason may be applied. If a trustee is required to sell vacant land, and fails to do so in a reasonable period of time, he may be compelled by the courts to act. Where the trustee has the option to exercise true discretionary powers, he generally remains immune to court interference: A court will not substitute its discretion for that of the trustee.

In rare cases, a specific power held by a trustee may terminate. Where, for example, a trustee is given the power by court order to sell a piece of real estate, and the trust property includes no other real estate, the power to sell may become extinct after the single sale.

Some general and widely accepted powers held by the trustee may be noted.

Power to sell. Because management of a trust corpus can and normally does require the trustee to buy, sell, and invest, he generally receives the power of sale. Most trust instruments dealing with assets of any complexity will grant that power by specific provision.

As mentioned above, if the terms of the trust instrument do not confer the power of sale, the trustee may be presumed, under some circumstances, to hold it anyway. The decisive factor will be the instrument itself. If its terms indicate an intent to grant a power of sale, the trustee can exercise that power under the appropriate circumstances. The trustee may also be given the power to sell by a court.

Power to borrow, pledge, or mortgage. A trustee will also, as a general rule, have the power to borrow money and pledge or mortgage trust property. But that power must be expressly granted by the terms of the trust agreement. Exceptions may be made, however, where state laws allow such an assumption. For instance, an emergency may arise, requiring that the trustee have substantial sums available; if the statutes of the state permit such action, the trustee may then borrow, pledge, or mortgage. Where no such statute exists, the courts hesitate to imply these powers out of fear that they may be abused.

Power to compromise. The power to compromise comes into play with reference to claims owned by the trust. The trustee, again,

must exercise judgment and prudence, but he can reach compromises on these claims, at least in those states whose statutes allow such methods of settlement. The trustee may also submit claims to arbitration—another form of compromise.

The trustee may have to show that the compromise was reasonable. The standard that may be applied is simple: Could the claim have reasonably been recovered in court? Or, did the trustee act reasonably in electing to compromise rather than enter into expensive litigation or simply surrender the claim?

Powers to contract and incur expenses. The powers to contract and to incur expenses flow out of the trustee's overall duty and power to act on behalf of the trust corpus. In other words, if he is to act, he may have to enter into contracts. Or, if he is to buy and sell, he may have to incur expenses.

The powers to contract and to incur expenses complement one another. A contract entered into as part of the management process may obviously make it necessary for the trustee to assume certain expenses. A contract to sell real estate, for example, involves varied expenses, all logically incident to the sale. Where statutes control the actions of trustees, it will often be specified that the trustee can incur reasonable expenses.

Powers relating to stocks and bonds. As holder of the legal title to the trust estate, the trustee must be able to exercise the normal rights of a stockholder. He may be dealing in large or small sums; not uncommonly, the trustee will invest six-figure sums in accepted, carefully chosen issues. In doing so, he must always exercise prudence, but the power to buy and sell securities remains his as part of his general management duties and powers.

Powers to lease. Management duties and powers also include the express or implied power to lease. In brief, the trustee must be able to lease trust property if he is to derive income from that property.

Where the terms of the trust instrument fail to confer the leasing power specifically, the trustee can assume that he can exercise it without authorization. Court decisions have held with some uniformity that the leasing power goes with the trustee's basic functions, with or without specification. The requirement that the trustee produce income from the trust simply takes precedence over any other assumptions. Even where the trustor specified that

the trustee hold land until it could be conveyed, courts have held that the leasing power was implied.

Power to use both income and principal for the beneficiary's advantage. Some very firm rubrics apply where use of either principal or income for the support and maintenance of the beneficiary is concerned. For example, the trustee has to make support and maintenance payments at reasonable intervals. He must, further, make such payments directly to the beneficiary. He cannot, without specific authorization in the trust agreement, choose the alternative of spending for the beneficiary's advantage.

The trust instrument usually gives the trustee discretionary power to apply portions of the principal to the support and maintenance of the beneficiary. Such power has to be exercised reasonably. The beneficiary should be properly educated, decently clothed, and so on. As a general rule, the expenditure of principal in those cases where the trust instrument allows it at the trustee's discretion

must be founded on a reasonable judgment dealing with existing facts and reasonable anticipations of the future, and having a due regard for the purposes for which the power was given, and also for the rights of those whose interests are injuriously affected by its exercise.²

Because discretionary powers are usually conferred in general terms, the trustee may face difficult decisions. A beneficiary may want to make the down payment on a house, or buy a yacht, or purchase a seat on the stock exchange. When deciding on such matters, the trustee must always apply "reasonable judgment." One trust agreement gave the trustee discretionary power to distribute trust principal for comfortable support and maintenance if, after considering the beneficiary's income and other circumstances, he thought the distributions were justifiable. The trustee asked for the beneficiary's tax returns for the preceding five years, then made a requested distribution of \$15,000.

In another case, a beneficiary asked for funds that would enable him to attend a school for racing-car drivers. The corporate trustee investigated. The school did in fact exist and had an outstanding

²Lovett v. Farnham, 169 Mass. 1, 6, 47 N.E. 246 (1897).

HOW DOES A TRUSTEE INTERPRET "COMFORTABLE CARE, SUPPORT, AND MAINTENANCE"?

Trustees continually encounter problems of interpretation. One of the trickiest areas involves provisions in a trust agreement that require the trustee to make discretionary decisions about whether or not to invade principal to provide "comfortable care, support, and maintenance" for a beneficiary.

Legal cases deal with the subject without settling the question of interpretation. In one case that never got to court, a trustor specified that he and his wife were to receive principal payments for their "comfortable care, support, and maintenance" while they lived. Regarding his sister, the trustor specified that principal could be invaded to the extent that the trustee deemed necessary for "care and maintenance."

The trustee decided that he was required to supply funds from principal for the sister's basic care and maintenance *only*—and that he was not "obliged to see that she was comfortable or properly supported."

This decision meant a number of things. For example, the sister's request that her rent be paid was valid, but payment of \$100 per month for an automobile could not be made. Health insurance premiums could be paid because "it would make good business sense to eliminate, conceivably, heavy expense for the trust later on." Payments of \$25 per month for "personal care," including hairdressers' bills, of \$25 for church contributions, and of another \$35 for recreation could not be made.

In making his judgment, the trustee took into account the amount of income received by the sister from other sources. The trustee had to make a virtually instinctual judgment in this area. The problem was simple: Cases dealing with the question whether and to what extent the trustee should consider a beneficiary's other resources in deciding whether to invade principal are not harmonious.

Similar considerations enter, of course, into decisions made where the trustor has specified that "reasonable," or "proper," or "adequate," or some other level of care, support, and maintenance is to be provided.

reputation. The beneficiary received the funds and did well in the course.

In a New York case, a corporate fiduciary with discretionary powers received a request from a beneficiary for \$9,000 to finance construction of a new carport. The beneficiary had been receiving income distributions of \$4,500 a month. While the trustee was considering its decision, an auto agency called to ask whether the

trust company was going to cover the beneficiary's \$9,000 check. The trustee said no to the agency—and the beneficiary.

Still other rules and practices may be noted. The trustee holding discretionary power to use income and principal for the beneficiary's support and maintenance has to give precedence to the life tenant. He cannot prefer the remainderman when making basic decisions in this area. If there are two or more beneficiaries, the trustee must consider both equally. He cannot do the minimum: He will be neglecting his duty if he distributes only enough to "keep body and soul together." But as a matter of course the amounts distributed will depend on the size of the trust corpus, on the standard of living of the beneficiary, and on other factors. The trustee may have to make allowances for the beneficiary's family situation. Where the beneficiary has a family, the payments from the trust fund may have to suffice to make a home for family members as well as the beneficiary.

Trustees generally approach with great care the task of making discretionary payments of income and principal. Error or failure in such cases may constitute a breach of trust. That, in turn, may mean litigation and assumption of personal liability.

- The trust corpus of Julia Murphy totaled only \$76,000. The trust income came to about \$5,400 a year. Asked by 22-year-old beneficiary Jeannine Burton for payments of trust income that would enable her to buy a car, the corporate trustee agreed. Jeannine was planning on using the car in her work. The time payments of more than \$200 a month would stretch out over a period of three years.

- A trustee in the Southwest freely (and without real justification) made principal distributions of more than \$200,000 to a single beneficiary over a six-year period. Another beneficiary found out about the distributions; he went to the trust company and asked that the \$200,000 be replaced in the trust corpus. Rather than risk having the case go to court, the company returned the \$200,000 to the trust—out of its own pocket.

More and more, corporate trustees are making decisions on discretionary payouts only after consideration of specific requests by a committee. In a medium-size bank, for example, such a committee will include the four to six officers assigned to the trust department.

RIGHTS OF THE BENEFICIARY

To some degree the rights of the beneficiary correlate with the duties of the trustee. The beneficiary has, first of all, the right to expect completely loyal administration of the trust corpus. He also has rights under the terms of the typical trust instrument. The trustor usually indicates the nature and extent of the beneficiary's interest. Sound legal doctrine holds that this interest entails rights against the world at large and not merely an equitable property right.

PROPERTY RIGHTS

The beneficiary's property rights are his alone. They cannot be restricted unless the trust instrument provides for such restriction. On the whole, they are treated in equity just as the trustee's corresponding legal interest would be treated at law.

Where there are two or more beneficiaries, they have equal rights. Legally they hold the property as tenants in common. Where control of property is at issue, a majority of beneficiaries cannot in any way prejudice a minority or assume any greater rights. Each beneficiary can act independently of all others and cannot be hindered in such action by the statements or admissions of any other beneficiary.

Transfers of trust property may take place by operation of law. In these cases, the transfers are called involuntary transfers. The beneficiary's estate in the property so transferred is treated in equity very much as a legal estate would be. For example, if the beneficiary dies intestate, his or her interest passes to statutory heirs in accordance with the local laws on postmortem distribution of property.

A beneficiary's interest in trust property may be transferred voluntarily—and legally—unless the trust agreement specifies otherwise. The beneficiary may also be stopped from making such a transfer by a statutory provision. But the transfer of an equity interest differs from that of a legal interest in one major respect: In the case of an equity transfer, some of the formality required in the legal transfer may be dispensed with. Transfers of equity and legal interests do, however, involve identical indications of capacity and intention.

MISCELLANEOUS RIGHTS

In other respects, also, the beneficiary has rights that parallel the duties of the trustee. The beneficiary can expect fair and equal treatment at the hands of the trustee. The beneficiary can also expect to receive information on the trust and its assets as and when he requires it. As regards trust income, the beneficiary should be able to depend on regular distributions. Other sequelae of the trustee's assumption of responsibility should become matters of course.

LIABILITIES OF THE BENEFICIARY

Liabilities, it might be said, inevitably accompany rights. But the beneficiary under a trust usually has only his generalized liability to the trust—and this liability arises out of his beneficial ownership of the trust property. The beneficiary does not have to reimburse the trustee for administrative expenses unless he has agreed to take the responsibility for such reimbursement. Nor can the trustee use the trust property to satisfy debts that the beneficiary owes the trustee.

Exceptions may be noted. Unless the trust has a spendthrift clause, or unless statutes contain specific prohibitions, the beneficiary remains liable in normal ways to the trust estate. For instance, if the beneficiary borrows from the trust corpus, the beneficiary would be held liable for repayment of the debt.³ In one case, the beneficiary owed money to the trustor.⁴ He was one of several beneficiaries, and it was held that the trust agreement did not absolve him of the debt.

A beneficiary may incur liability by dealing wrongfully with trust property. In such a case, it has been held that the loss can be made up from the beneficiary's equitable interest in the trust property. The beneficiary may also be personally liable for repayment if he is overpaid, even if he is overpaid in error. He cannot, in other words, simply claim overpayment as his just due; it does not matter that the overpayment was inadvertent.

A beneficiary incurs the same degree of liability that any other

³*Humbird v. Humbird*, 162 Md. 582, 160 Atl. 623 (1932).

⁴*Sheridan v. Riley*, 133 N.J. Eq. 288, 32 A.2d 93 (1943).

person would incur as a result of a breach of trust by participation or collusion with others. One of several beneficiaries has in given cases persuaded a trustee to loan or distribute trust funds without proper authorization. The beneficiary in each instance was held to be responsible to the cobeneficiaries. It has even been decided that the offending beneficiary's portion of the trust estate should be subject to an equitable lien in favor of the other beneficiaries.

In some cases, a beneficiary tries to bring undue pressure to bear on the trustee. Where this occurs, with the beneficiary insisting on an unauthorized action, the trustee remains liable. His fiduciary position does not relieve him of responsibility; rather, it requires that he resist such influence. However, where beneficiaries have actively interfered with the trustee's actions, they cannot later bring legal action against the trustee. They can, in fact, be viewed as having conspired in the breach of trust.

Both the spendthrift and the protective trusts described earlier restrict the power of the beneficiary to act, in particular to transfer property. In general, the beneficiary who violates such restrictions, or who attempts to, incurs direct liability for his actions; but this statement requires qualification. Many states permit a trustor to place restraints on the beneficiary's right to alienate or transfer property or an interest in such property. The restraints may apply whether they refer to trust income, trust principal, or both. But in some states, no restraints on transfers of principal are held to be legal; and in a few jurisdictions, no restraints on either income or principal will be held to be binding if included in the trust instrument.

Usually, however, the intention of the trustor takes precedence. No specific wording is required to establish a spendthrift trust. If the terms of the trust agreement clearly show that the trustor intended to place restraints on the beneficiary's power to alienate, that intention will influence the decisions of both trustees and any courts that may have jurisdiction.

Chapter 12

TAXES, NONTRUSTS, PROBATE, AND TAX REFORM

The scenario could have taken place in any law office or bank conference room.

"I'm willing to consider a trust," Patricia Berg said. "But tell me this: Is it true that if my estate were valued at \$177,000 when I die, I would pay 32 percent of that total in federal estate taxes?"

"Yes," Patricia's lawyer said. "Even though the unified estate and gift tax rates begin at 18 percent, the rates between 18 and 32 percent in effect are never assessed."

"Then you advise a trust?"

"Since your estate is actually valued at nearly \$200,000, I do. You have specific purposes that you want to accomplish other than tax savings. Why not make sure the greatest possible percentage of your estate goes to those people you want to help?"

"But think of the charges! The bank wants to place my assets in one of its common trust funds. That means they administer everything in that fund in the same way—and charge for every \$1,000 in the fund."

"You can specify that the assets are to be administered as a separate investment fund if you want to."

"I'll think about that," Patricia said. "In any case I'll save on taxes. And I will avoid probate and all the probate charges."

"Of course."

"Can't I achieve the same thing just by putting everything I own into one of those mutual fund trusts?"

"You can do that if you want to. But I'm advising against it. Those aren't really trusts."

"They aren't? Why do they call them trusts?"

"Because they share some of the features of genuine trusts. But they aren't trusts as I've been explaining them to you."

"Tell me more."

"First of all. . . ."

TAX NOTES

Books have been written about the tax aspects of trusts. Many of the key facts have already been noted in the preceding chapters, but some other basic points should be made.

For example, the simplest way to avoid payment of taxes on property that you own is to give it away. But you may want to give the property to your son, who is 16. Even if he could, he might not manage the property wisely. So you decide to give it in trust. In that process, you give up the right to collect the income from the property and may also surrender the right to modify or revoke the trust agreement. You have now given up the incidents of ownership on your property. Your income taxes are substantially reduced—or eliminated—because you are no longer receiving the income on the property.

An irrevocable trust can have almost automatic tax-sheltering aspects. To a lesser degree, other types of trusts can share this characteristic.

For another example, the taxation of simple and complex trusts is different. In fact, the two types of trusts differ fundamentally. In a simple trust all the income for the taxable year is distributed, the corpus remains undistributed, and the trust instrument does not provide for a charitable deduction. The complex trust lacks one or more of those three features. Its income, or part of it, is allowed to accumulate, a portion of the corpus may be distributed, and the trust instrument may provide for a charitable deduction.

A trust can be a simple trust one year and a complex trust the next. In the second year, for example, the trustee may have been required to distribute part of the corpus of the trust. Thus, the trust would lose its "simple" status for that year.

Some other key tax aspects of trusts are discussed in brief below.

GIFTS IN TRUST

Gifts in trust are more numerous than outright gifts of property by a substantial margin, and for obvious reasons. The gift given by means of a trust escapes taxes that might make the cost of an outright gift prohibitive.

In one case, Martin McCoy, possessor of a \$5 million estate, decided to give portions of his property to his wife, Marian. In 1971, 1972, and 1977, he gave Marian gifts of \$450,000, \$450,000, and \$900,000.

Martin had to pay gift taxes of \$14,840, \$74,920, and \$166,530 on the three gifts. Thus, he encountered actual costs of \$464,840, \$524,920, and \$1,066,530, respectively. When Martin died in 1978, he retained only \$2,943,710 of his original estate.

By creating a trust, Martin could have avoided most of the gift taxes he actually paid. He could have transferred his wealth in diverse ways, depending on such factors as the number of beneficiaries and whether he made provision for a charitable remainder. The trust, in effect, would have opened many options.

INFLATION AND TAXES

Galloping inflation combined with tax law complexity have combined to make the task of the forward-looking trustor more and more difficult. Increasingly, the future-aware person calls on his accountant as well as his lawyer when trying to map out an estate plan. He may also consult his insurance man and a corporate trustee.

Some statistics will explain why. At one time, providing for a 6 percent annual inflation rate seemed not only logical but acceptable. That rate, in fact, looked high not too many years ago. According to published figures, consumer price inflation on all items ran at an average 4.0 percent rate for the 20 years preceding December 1977. For the 15-year period prior to that date, the average inflation rate was 4.9 percent. The 10 years prior to December 1977 saw an average inflation rate of 6.4 percent. And in the five years preceding the same cutoff month, the average rate was 8.2 percent.

Double-digit inflation has now become the rule. Because of inflation, some of your assets—and your money itself—are losing value at the rate of 10 percent and more per year. How can you

keep up with it? How can you reduce your taxes in a system that has increasingly been closing in on tax loopholes and—more pertinently for us—tax breaks for trusts?

Plan, say the experts. Look at the overall situation with an eye to keeping pace with both inflation and tax changes. Make certain your return on investments, the inflation rate, and your life expectancy, expenses, and estate value come into some kind of balance. Read the next chapter. Make certain trusts are kept in view as possible tax-avoidance techniques.

CAPITAL GAINS

How do you plan when uncertainties cloud the tax picture? When income taxes and capital gains taxes represent huge question marks?

It's not easy.

Take capital gains taxes as a case in point. If you were trying to develop an estate conservation and trust plan in 1979, you faced a difficult situation. Say you had a few securities, all chosen with an eye to risk measurement and probable return on investment, and also owned some real estate. Washington would have put you in a bind. In the fall of 1978, Congress voted to delay until 1980 its confirmation of a 1976 law whose purpose was to tax heirs and trusts on increases in the value of property that took place while the former owners were alive. All such predeath capital gains escaped taxation before 1976.

In its deliberations Congress, had three ways to go, all of them pertinent to estate planning and trust creation:

1. Allow the 1976 law to go into effect, thus permitting taxation on predeath capital gains.
2. Kill the postponed law and return to the old no-tax system.
3. Devise a new method of taxing capital gains at death.

What was the outcome? Simplicity prevailed. The old law was allowed to die. The rule that once applied still holds: the valuation of property made six months from the date of death determines the cost basis of the trust property. You do not have to pay taxes on appreciation that might have taken place while the former owners were alive.

DISCLAIMERS

The charitable remainder trust gained a new wrinkle with passage of the Revenue Act of 1978. By the terms of that law, the so-called disclaimer—the method by which a beneficiary utilizes his option to turn down a bequest to let the property pass to an alternate beneficiary—came even more into its own. Essentially, the Revenue Act liberalized the use of disclaimers, especially where surviving spouses were concerned. Thus, a new approach became possible.

For example, Steve Thorson bequeathed \$100,000 to his wife, Mary. But he provided that if she were to disclaim his bequest the funds would go into a charitable trust. The latter would pay income to Mary for the remainder of her life. That income would be used also to provide support for Mary's mother for her life.

Mary had the option of a \$100,000 lump-sum payout or income for life from the trust. She could also claim an estate tax charitable deduction if she chose to receive income for life. Not incidentally, a worthy charity would eventually be aided.

THE LOW COST OF GIVING

Yet another aspect of charitable giving should be noted: Your support of a worthy charity can still save you money. You may want to give judiciously, of course. But the charitable donation can still skim off the upper part of your estate and bring it into a lower, more manageable tax bracket.

How substantial the tax rewards for support of a charity can be is shown in Exhibit 7. The table is based on a gift of \$1,000. The figures for cash gifts show the cost of a gift after you have subtracted the tax dollars saved because of the \$1,000 charitable deduction. The figures for gifts of appreciated securities or property that are held for more than one year reflect savings from the capital gains tax avoided on the donor's paper profit. The rewards are shown for both single taxpayers and married persons filing jointly.

TAX SHELTERING AND SAVING

Case after case cited in this book have indicated how trusts can both shelter principal or income against taxation and save on taxes.

Exhibit 7. Tax rewards for a gift to charity.

Your \$1,000 Gift, After Taxes, Will Cost Only:												
If Taxable Income Is:	Appreciated Securities or Property Valued at \$1,000											
	Cash Gift of \$1,000		\$200 Paper Profit		\$400 Paper Profit		\$600 Paper Profit		\$800 Paper Profit		\$1,000 Paper Profit	
	Single	Joint	Single	Joint	Single	Joint	Single	Joint	Single	Joint	Single	Joint
\$ 10,000	\$790	\$820	\$773	\$807	\$756	\$791	\$740	\$777	\$723	\$762		
15,000	700	790	676	773	652	756	628	740	604	723		
20,000	660	760	633	741	606	722	578	702	551	683		
25,000	610	680	579	654	548	629	516	603	485	578		
30,000	560	630	525	600	490	571	454	541	419	512		
40,000	510	570	471	536	432	501	393	467	353	433		
50,000	450	510	406	471	362	432	318	393	274	353		
80,000	370	460	320	417	269	374	219	330	168	287		
110,000	300	360	244	309	188	258	132	206	76	155		
170,000	300	320	244	266	188	211	132	157	76	102		
220,000	300	300	244	244	188	188	132	132	76	76		

The trust accomplishes these goals in two key ways: by dividing income among beneficiaries and by withholding ownership rights.

The principles behind such advantages are simple. If income can be spread among a number of taxpayers, the overall result may be lower taxes. "Splitting"—or taxing more than one individual—lowers the tax brackets and, in consequence, the tax.

A similar principle applies where ownership is withheld. A woman may, for example, create a trust with only a portion of her estate. The trust is set up in such a way that the husband is not considered the owner of the property placed in trust, but he receives all of the trust income and its principal, if needed, to maintain his standard of living. If the wife dies first, the property in trust will not be subject to federal taxes on her estate, because, in tax terms, she cannot be considered the owner.

NONTRUSTS

As in all other fields in which large sums of money are involved, ax-grinders and promoters have invaded the trust field. They have done some good along with much harm.

Some of their "trusts" don't qualify. The courts disagree on some specific trust formats.

TOTTEN TRUSTS

Although in most states bank account trusts are recognized, in Illinois and a number of other states the Totten trust remains invalid. The courts in these states have simply refused to acknowledge that it ranks as a genuine trust.

What happens, and why? In a recorded case,¹ Earl L. Montgomery filed a petition on his own behalf and as administrator of his wife's estate to find and recover the funds in eight savings accounts. Montgomery claimed that the funds constituted part of his deceased wife's estate. As administrator, he should, he said, have control over them.

Bernice had opened the eight accounts and named as beneficiaries her two children by a previous marriage. She and Montgomery had been married 27 years. Testifying that he was not

¹Montgomery v. Michaels, No. 45031 (Ill. Sup. Ct., filed January 26, 1973).

aware of the existence of the accounts, Montgomery contended that all eight were illusory. If sustained as trusts, he said further, the accounts—Totten trusts because the funds had been deposited “in trust for” the beneficiaries—would represent an invasion of his statutorily protected marital rights. They would undermine his statutory right to one-third of the decedent’s estate.

The Illinois Supreme Court upheld Montgomery’s claims on crucial points. It said that the accounts were testamentary in nature. Further, they did not defeat the plaintiff’s right to a distributive—one-third—share in the decedent’s estate. In other words, a Totten trust is not even a tentative trust in Illinois.

THE MUTUAL FUND TRUST

The winds of controversy that have blown occasionally across the trust field have turned up some other leaves.

The problem with the nonbinding Totten trust in Illinois and other states is that the trustor retains control of the savings account. He can draw on it at will while alive; but if he is incapacitated, a serious question arises as to who can draw on it.

The mutual fund trust raises another problem: It provides people possessing money to invest with a trust arrangement that has almost none of the key characteristics of a true trust.

Let’s look at a case. Constantine Lawrence, crippled in an auto accident at the age of 42, lived off his wife, Jeannine. The latter had a respectable fortune of \$220,000, all inherited from her late father.

Before her death from cancer, Jeannine placed all her property in a mutual fund trust. Although the trust paid out income for Constantine’s benefit after Jeannine’s death, the mutual fund owned all of Jeannine’s assets and did not provide the usual trustee services. Constantine was locked into an unpleasant—to say the least—situation.

In Constantine’s case, the mutual fund did not provide anything near the income he required for his support and maintenance. He could not change the trust arrangement, which became irrevocable after Jeannine’s death. And the mutual fund did not allow for an invasion of principal on the demand of the beneficiary, Constantine. Nor was a trust officer, if such existed, empowered to pay Constantine’s bills and maintain him.

Because of public outcries, mutual funds have eased their

policies to some extent. For example, form trust instruments may today permit invasion of principal, but it often remains difficult for a beneficiary to contact a “trust officer” at the mutual fund’s headquarters. And in most cases the fund headquarters are located in New York or some other eastern seaboard city—thus, compounding the communications problem.

The duties of a trustee can be discharged only by a genuine trustee; only a trustee can provide the needed services. Also, where the mutual fund trust operates under minimal controls, the typical corporate trustee is constantly checked and audited by both state and federal agencies and is bonded against thefts or losses as well.

As if that were not enough, the fees charged by the mutual fund trusts may run well above those of the typical corporate fiduciary. The mutual fund may charge an 8 percent commission. It may charge a trustee’s fee while also taking a management fee for the firms engaged to manage and handle the investments for the mutual fund.

THE POD ACCOUNT

Widow Mary Jane Tennant had unlimited confidence in her children. They had comforted her through her middle years and on into her early old age. She decided on a simple solution that, she believed, would provide for herself and the three siblings, all in their forties.

Mary Jane decided to create a trust. Mainly, she wanted to avoid probate. She had an estate valued at \$350,000. To “simplify her life,” she sold her house, moved into a modified retirement home, and invested nearly all her money in time certificates of deposit. The pseudotrust she established in this way provided on the certificates of deposit that the certificates would be “paid on death” (POD) to her children in equal shares. The key provision read:

Mary Jane Tennant, POD (paid on death)
Mary Ann, John, and Philip Tennant (my children).

When Mary Jane died, the securities passed at once to her children. In essence, she died broke. Her children flew into the town where she had been living, attended the funeral, and took

over title to the certificates of deposit. Then they flew out again, without so much as making sure their mother's obligations and funeral expenses were taken care of.

In those states that permit investors to open savings accounts or purchase certificates of deposit, the POD "trust" has become relatively common. But the owner of the certificates or accounts retains exclusive control over the property. So the trust is not really a trust, even though it enables the property owner to avoid probate. The property does, of course, by law pass to the so-called beneficiaries.

PROBATE: TO AVOID OR NOT TO AVOID?

Mary Jane Tennant's case raises a question: To what lengths should you go to avoid probate?

One sensible answer might read: Only as far as you have to go to achieve some more basic goal.

Don't, in other words, move heaven and earth to avoid probate just for the sake of avoiding it.

As a legal construct, probate serves fundamental purposes. For example, it protects the survivors of a deceased person by requiring proof that a will is genuine. Typically, the executor of a deceased's estate brings the will to court and shows evidence that the will was actually made out by the deceased. In the probate process, the court issues notices to all the heirs who would have shared the property if no will had been drawn up.

When the will comes before the probate, or surrogate's, court in a hearing, any possible heir has the right to object to the terms of the will. The probate judge hears all claims. Witnesses are examined just as they would be in a civil suit. The judge then decides whether he believes the will is genuine.

If the will is declared valid, it is approved and registered. The executor carries out its provisions.

THE TRUST ALTERNATIVE

We are not considering here the possibility that you might die without having made out a will. Where that happens, you place your estate at the tender mercies of the laws of the state in which you reside. The consequences can be disastrous. Your estate must

still go through probate, but distribution will be made according to formulas contained in the laws.

To cite only one case, Mel Byrd placed most of his rather sizable estate in his wife's name. He assumed that his wife, Florence, who was both younger and healthier than he, would survive him. He wanted primarily, of course, to save estate taxes.

Mel's wife predeceased him, leaving no will. Her parents and a sister had died before Florence, but one brother and a niece survived her. Florence hadn't seen the niece in 22 years. To whom did the property go? Under the laws of the state in which Byrd lived, to the brother, the niece, and Mel—after Mel had received an initial payoff of \$10,000.

The trust alternative that enables the property owner to avoid probate is real; the question to be answered relates to the number and significance of the other advantages to be derived from avoiding probate.

PROPERTY THAT CAN AVOID PROBATE

What property can pass from one generation to another without passing through the probate process?

Most simply, nonprobate property—property *not* subject to probate—includes those items that are held in joint tenancy. It also includes life insurance (unless the estate of the insured has been named a beneficiary) and any other asset whose title specifically states what will happen to the asset if the owner dies. Thus, probate property is property held in only one person's name and on which no specification has been given regarding transfer or passage at death. The probate process takes care of the proper distribution of such probate assets.

THE PROTECTIVE FEATURES

As indicated, intestate law applies where a person dies without leaving a will. In effect, the state of residence provides a kind of will under which property is distributed if a person leaves no will.

The protective features of the probate process can be capsulized in a number of questions. For example, what if evidence indicates that the will was procured through the use of undue influence? What if the will is unclear? What if the person making out the will was not of sound mind? Who makes sure that the decedent's taxes

and just debts are paid? What if the executor has made a serious mistake? What happens if someone disputes a debt?

Probate also requires that a decedent's survivors, or one of them, catalog and place a value on all the decedent's assets. Typically, the executor or someone assigned by the court has to go through, inventory, and appraise the decedent's possessions.

The trust eliminates such inventorying. Where a trust is involved, the trustor has already listed and placed in the trustee's possession all the assets that are to go into the trust estate.

THE ARGUMENTS AGAINST PROBATE

Justly or unjustly, probate has been criticized as a system of exacting tribute from grief-stricken survivors. Specifically, it has been said to exist principally for the enrichment of members of the bar, to cost too much, to take too long, and to involve too much publicity.

Does it do these things? Certainly it was not established to line the pockets of lawyers. It was established to ensure that justice is served to the greatest degree possible in the settlement of estates. It probably does not cost more than a reasonable amount, considering that probate involves a one-time fee that is geared to the size of each individual estate. The cost of carrying a \$100,000 estate through probate may typically run about \$3,500 in attorney's fees. It might run higher or lower depending on the area.

Usually, the local or state bar association establishes a fee schedule for probating an estate. The fees are expressed as percentages of estate value. On estates of \$500,000 or less, the fees average about 3–4 percent. Sometimes, however, the fees are negotiated by the decedent before his death or by the executor after the decedent's death. This occurs, usually, where a very large estate is involved.

A professional or corporate executor would of course charge other fees. A relative who serves as executor may charge no fee at all.

On the positive side, too, probate protocols set time limits on claims against estates. Generally, a claimant has six months in which to file a claim, beginning on the date on which an executor is appointed. The claim formality requires that a claimant prove he has a legal, justifiable claim.

As for the other arguments, probate *can* take “too long”—that is, if two or three years, or in a few cases five to ten years or more, is considered too long. The time involved in the process depends on the kinds of assets in the estate and on death tax problems. Understandably, the heirs to an estate usually want to see the probate process completed as quickly as possible, but they may forget that long periods of probate may result in tax advantages for the beneficiaries.

As for “too much publicity,” in some cases *any* publicity is too much. In other instances, and these represent the great majority, the estates passing through the probate process do not really attract publicity, but anyone seeking information can consult the public record and find out what occurred. There remains this fact: If you are trying to avoid having your estate and its disposition placed on the public record, probate does violate your intention.

ON BALANCE

A balance sheet would show that probate plays one very useful and definite role; the trust has another different purpose. These goals should not be confused: A trust is not, and never was, intended *primarily* as a means of avoiding probate of an estate.

The trust, as I’ve said before, must fit your needs. It must fulfill your intentions regarding the property you own or plan to own. It may limit your free use of your property while you are alive, because in executing the trust agreement you may be transferring legal title to that property to someone else.

Few people who have any real knowledge of the probate system as it presently exists (in somewhat different forms in different states) would want to have it abolished. The fact that a trust enables you to avoid probate does not change this. A decision to avoid probate by establishing a trust should be made *only* after careful review of your assets and your intentions regarding them.

TAX REFORM 1976

The most important aspect of the Tax Reform Act of 1976 was the introduction of a new element into estate taxation: the carry-over basis for computing federal income taxes on capital gains realized by estates and beneficiaries. Congress, however, suspended the

carry-over rules when it passed the Revenue Act of 1978. In 1980, a catchall bill on windfall profits on oil and gas contained a provision that abrogated the carry-over provision of TRA '76.

WHAT IS CARRY-OVER?

Technically, carry-over refers to determination of the actual cost basis of assets, with an upward adjustment of that valuation to account for the federal estate taxes paid. The carry-over principle in application produces little besides burdensome work and endless, mind-boggling reporting, bookkeeping, and accounting problems.

A medium-size estate might, for example, include a modest amount of personal property. Under the carry-over rules, the requirements for determining a basis for that property extended to each and every stamp in a stamp collection, or coin in a coin collection, and also to items of jewelry, silverware, or plate. All securities had to be evaluated and given a basis.

Imagine other carry-over complications. You received two shares of stock from your grandfather and have added 29 shares for a total of 31. Each stock item would have to be given a date of acquisition and a basis.

Inherited property would present other problems. But despite them, taxes would have to be paid on the calculation of depreciation. Carry-over, in sum, not only represented an area whose parameters and details were difficult to learn, it opened a Pandora's box of reporting and bookkeeping challenges.

Trust officers throughout the United States breathed a sigh of relief when the abrogation of the carry-over regulations became permanent in 1980.

GIFT TAXES

Because it introduced sweeping revisions of estate and gift tax laws, the Tax Reform Act of 1976 launched a new era in financial planning. The changes affected millions of Americans, starting particularly in 1977. The law eased tax burdens for many and imposed stringent new restrictions on others.

Today a key question is posed for those who are or may be liable for gift taxes: Do you want to pay them now or later? Otherwise expressed: Do you want to pay them during your lifetime or after death? The new dispensation comes about because the separate

Exhibit 8. Unified federal estate and gift tax rate schedule.

(A)	(B)	(C)	(D)
<i>Taxable Amount Over</i>	<i>Taxable Amount Not Over</i>	<i>Tax on Amount in Column (A)</i>	<i>Tax on Excess Over Amount in Column (A)</i>
\$ 0	\$ 10,000	\$ 0	18%
10,000	20,000	1,800	20
20,000	40,000	3,800	22
40,000	60,000	8,200	24
60,000	80,000	13,000	26
80,000	100,000	18,200	28
100,000	150,000	23,800	30
150,000	250,000	38,800	32
250,000	500,000	70,800	34
500,000	750,000	155,800	37
750,000	1,000,000	248,300	39
1,000,000	1,250,000	345,800	41
1,250,000	1,500,000	448,300	43
1,500,000	2,000,000	555,800	45
2,000,000	2,500,000	780,800	49
2,500,000	3,000,000	1,025,800	53
3,000,000	3,500,000	1,290,800	57
3,500,000	4,000,000	1,575,800	61
4,000,000	4,500,000	1,880,800	65
4,500,000	5,000,000	2,205,800	69
5,000,000	—	2,550,800	70

systems for taxing lifetime gifts and estates at death have been merged into a single structure. The same federal rate schedule applies to both taxable gifts and the estates of decedents (see Exhibit 8).

The Tax Reform Act contained a paradox. While the new unified rates are somewhat higher than the old, ranging from 18 to 70 percent, the majority of estates will pay less tax and a significant number will escape the gift tax entirely.

How do higher tax rates produce less tax? First, the unified credit replaces the \$60,000 estate tax exemption and the \$30,000 gift tax exemption. The credit, as noted, started at \$30,000 in 1977 and was scheduled to rise to a maximum of \$47,000 in 1981. The full \$47,000

WHAT IS A GIFT?

The Internal Revenue Service has defined a gift in specific, relatively understandable terms. The "Instructions for Form 709 (Revised February 1977)" give the following definition under the title, "United States Quarterly Gift Tax Return."

The Federal gift tax applies to any gift by an individual of real or personal property, whether tangible or intangible, and whether given directly to a donee, in trust, or by any other means. The tax is applicable to the gratuitous transfer of all types of property or interests in property, including, for example, real estate, securities, life insurance policies, annuities, contract rights, jewelry, art objects, and personal belongings. The gift tax is applicable regardless of whether any other tax, such as Federal income tax, has been paid or is payable with respect to the transferred property.

credit, equaling an *exemption* of \$175,625, operated to cancel the lower tax rates. The lowest effective rate on the unified rate schedule thus became 32 percent in 1981.

A second factor serves to hold down estate taxes for married couples: The new law raised the marital deduction ceiling to \$250,000 or one-half the estate, whichever is greater. Starting in 1981, the \$47,000 tax credit in combination with the \$250,000 marital deduction now allows more than \$425,000 to pass estate-tax free to a spouse on a married person's death. The hooker: Without a trust or other special arrangement, the marital deduction only postpones all or some of the tax bite until the surviving spouse dies.

Gift taxes and generation-skipping trusts. A trust frequently adds up to a method of making a gift. The recipient—the beneficiary—may or may not be known to the trustor. But this beneficiary will, under the trust terms, at some point in the future receive all or part of the trustor's estate—in effect, a gift.

TRA '76, as indicated earlier, raised a new specter for existing or to-be-created generation-skipping trusts. As a favored method of making gifts across time and generations, the generation-skipping trust suddenly found itself face to face with the requirement that a "generation-skipping tax" be paid.

Clever gifting. TRA '76 imposed a tax on all generation-skipping

transfers in excess of \$250,000, but it did not place a tax on outright transfers to grandchildren. Thus, clever gifting can still accomplish the purposes of the generation-skipping trust.

Mervin Hawes found one obvious way out. Possessor of an estate valued at \$2.5 million, Mervin first provided a lifetime annuity for himself. Then he invested in a series of lifetime annuities for his four children. Finally, Mervin created an inter vivos trust for his grandchildren, all six of whom were under age when the trust came into being. The trust in effect gave the entirety of Mervin's estate to the grandchildren in equal parts. By this means, Mervin not only avoided the generation-skipping tax but also sheltered subsequent appreciation of his estate from at least two tax bites: the trustor's estate tax and his children's estate tax.

TRA '76 had the obvious purpose of curtailing the avoidance of transfer taxes through creation of inter vivos, generation-skipping trusts. All transfers, whether by gift or by death, were to be subject to the same unified tax rates and credits.

Lifetime transfers can still be advantageous. They do result in prepayment of the transfer tax, but they eliminate future appreciation from the owner's estate—a major factor in an inflationary economy.

Mervin's method was to provide a substantial lifetime income for himself and his wife in the form of annuities. He did the same for his children. Then he made a transfer directly to his grandchildren by means of a trust. The trustee—in Mervin's case, a bank trust department—took over full responsibility for administration of Mervin's estate once he had retired from active business life. The trustee, of course, took care of all accounting, tax filing, and other administrative tasks connected with Mervin's trust estate.

Chapter 13

TRUSTS IN ESTATE PLANNING

Think it over. You have \$100,000 in life insurance. You own a home whose value has risen substantially—if not astronomically—over the past 15 years. You have a few stocks and bonds. Your pension and profit-sharing benefits will produce income after your retirement.

Adding it all up, you come to the conclusion that your heirs will be fairly well provided for when you have stepped out of the picture. As nearly as you can figure, your estate will have a value of about \$190,000.

A trust?

The answer to that question depends on a number of factors. You know, since it's 1982, that your estate will be taxable under federal law because the total value will exceed the \$175,625 minimum that is subject to taxation. State inheritance taxes will also be levied on your heirs. Still, you want to plan, at least to some extent, the disposition of your estate. Avoiding unnecessary taxation represents a basic motivating factor. Why give part of your estate to Uncle Sam? That's the question you put to yourself.

You are also trying to keep yourself in perspective regarding age and life expectancy. In planning your estate with the collaboration of your spouse and with the help of your lawyer, you keep some principles in mind.

You examine sample trust documents. Some, such as the testamentary types are long and involved. Scrutinizing, you realize that the verbiage spells out the powers and duties of the trustee in great detail. The pour-over will that goes with one particular testamentary trust is a page and one-half long. So far, so good.

GUIDING PRINCIPLES

"When I receive an invitation to speak before groups," a trust officer said, "I ask about the ages of the people who will make up the audience. If they tell me that all my listeners will be middle-aged or elderly—'ready for information on trusts'—I say I'd rather talk to younger people.

"The reason is simple. The younger person should consider a trust even if he doesn't have a large estate. If you have any future prospects at all, or insurance, or if home ownership is involved, the time to start thinking about a trust is when you're still building the estate. That way, you get the most out of the trust."

Ideally, estate planning should begin when a person is getting fully into his career. The trust, as a key-estate-planning tool, should at least come under consideration when the person starts the planning process. A rule of thumb indicates that estate planning should start at the age of 35. If you wait until 45, you may be in trouble.

Taking such an approach, the potential trustor can view his future situation in realistic terms. He can integrate estate-building steps into a plan that will most effectively fulfill hopes and discharge responsibilities. Insurance becomes one means of providing for loved ones and of building an estate; corporate or individual benefit or retirement plans may be found to represent basic elements in the developing picture of one's net worth.

What will your estate include? At the least, it will consist of:

- All the property that you own in your own name, with a value to be established at the date of your death.
- All or some part of the property that you own with your wife or other person as joint tenant with right of survivorship.
- The proceeds of life insurance policies.
- Pension and profit-sharing benefits payable to your estate.
- Assorted other assets, including personal property.

Your estate will be charged, of course, for debts, funeral expenses, and all costs of estate administration and settlement.

What guiding principles should you keep in mind as you start planning your estate? With trusts in the background as a distinct possibility, at least five general rubrics are important.

1. It's never too early to begin planning your estate. The younger person launching a career of any kind may be the perfect candidate for an estate-planning session—and a trust arrangement.

Whatever your age, four factors are generally considered basic to effective estate planning: life insurance, your residence, your income, and your savings account holdings in securities. The four have short-term utility value during your life: They help you provide for your own needs and those of others close to you. But they also have long-term meaning insofar as your objectives are concerned. They will become functional particularly in your efforts to provide for the significant others in your life when you are disabled, retire, or die.

You will want to keep both the long-term and the short-term goals in focus as you consider the other guiding principles.

2. It's wise to investigate how income and assets may be shifted so as to minimize future tax and other liabilities. The shifting process can take place in different ways, obviously. But a trust, with all that it entails in assignment of legal title to a trustee and equitable title to a beneficiary, may possibly provide the ideal method.

3. List at least informally the needs of those who are to benefit from your estate; express your own desires regarding their future comfort and welfare. Those who are to benefit may be many or few. They may be relatives, friends, acquaintances, or strangers belonging in a special category deserving, or requiring, charity. But these beneficiaries are people and should be viewed as such.

4. Approach your assets with the realization that their true value will not be their net worth but their income-producing capabilities. Where assets have income potential, in short, they may, as capital, be self-perpetuating or self-regenerating. Income-producing potential deserves consideration at any time, but it becomes crucially important when the estate owner or trustor retires or dies. From that point on, the income yielded by the estate has to replace, insofar as possible, the trustor's earned income.

5. Avoid any unnecessary tax liabilities, through all available, legitimate means. A sound business principle, this rubric in no way suggests that tax evasion, a federal crime, should be practiced.

Rather, the principle indicates the continuing need to take into account the cost basis of the estate transfer plan—whether by trust or other means. The rubric encourages wise tax avoidance, a completely legal goal.

THE INVENTORY

A trust now lies in the background of your thinking as a distinct possibility. You have a plan for developing an estate on the basis of five sound principles. You have separated your objectives into long- and short-term types.

You need an inventory of your estate as it exists at present. Exhibit 9 shows one way to draw it up.

Be prepared for a surprise. Adding up what you own and what you expect to inherit or otherwise receive from others, insurance proceeds, and additional assets, you will probably find that you are worth much more than you ever thought possible. Your inventory need not, however, produce exact figures. In the normal case, it can proceed through several widely accepted steps.

Step 1. Draw up a list of all your assets, including those that can reasonably be anticipated by way of inheritance or otherwise. Current income ranks as a key item. Each asset should be listed with its cost, approximate current value, and probable value at a point in the future that you might reasonably expect to reach before death. The cash value of insurance should be noted as current value; the face value should be set down as date-of-death value. Insofar as possible, the value of business interests should be noted separately. The assets of every member of your immediate family should also be listed on separate sheets.

Step 2. Divide your assets into three categories: those that represent cash, those that should or will be converted into cash, and those that you want to retain in their present form. Against these figures, place estimates on the cash requirements of the estate. If necessary, reconsider the classification of your assets and make changes where needed. Additional assets may, for instance, be classifiable with those to be retained; others initially marked for retention may have to be sold to increase cash reserves.

Step 3. As exactly as possible, estimate the liabilities that the

Exhibit 9. Capsulized version of an inventory outline.

1. Real Estate

<i>Description</i>	<i>Value</i>	<i>Mortgage or Other Financing (balance owed)</i>	<i>Title</i>

2. Personal Items

<i>Description</i>	<i>Value</i>	<i>Financing (balance owed)</i>	<i>Title</i>
A. Automobile			
B. Boat			
C. Household goods			
D. Other			

3. Cash, Stocks, Bonds

<i>Description</i>	<i>Value</i>	<i>Encumbrances (if any)</i>	<i>Title</i>
A. Bank accounts			
B. Stocks			
C. Bonds			
D. Promissory notes			
E. Contracts for deed			
F. Other			

4. Life Insurance

<i>Company</i>	<i>Policy No.</i>	<i>Face Amount</i>	<i>Owner*</i>			<i>Beneficiary & Method of Payment</i>	<i>Encumbrances (if any)</i>
			<i>Type</i>	<i>Yes</i>	<i>No</i>		

5. Employee Benefits

<i>Description</i>	<i>Value</i>	<i>Beneficiary</i>
A. Pension benefits		
B. Profit-sharing benefits		
C. Stock options		

6. Other Assets

7. Liabilities (not shown above)

<i>Description</i>	<i>When Due</i>	<i>Terms</i>
A. Notes		
B. Other		

*The owner is usually the one with the right to designate the beneficiary.

estate will have to meet out of postdeath assets. These debts and claims could include income tax levies, funeral and last illness expenses, any debts, and administration costs.

Step 4. Deduct the estimated debts and claims from the total estate as it will exist when you die, then calculate the amount of estate taxes that will be due. Prepare a set of figures on the tax liabilities of your estate (and your spouse's, if you are married and both of you have estates). From such figures, you can estimate further what would be left for your children or other beneficiaries if both you and your spouse were to die within a short period of time. If a marital deduction is to be claimed, the tax effects of the earlier death of each spouse should be calculated. Thus each contingency can be provided for; tax liabilities, debts, and expenses can be added together to show the total cost of transferring the estate to the beneficiaries.

Step 5. Estimate the tax and other advantages and disadvantages of making out a will and creating a trust. Remember that you will want the greatest possible portion of your estate to reach your ultimate beneficiaries.

Mention of beneficiaries brings up another basic consideration: Who are the people involved? Or, for whom do you feel obligated to provide?

THE PEOPLE INVOLVED

Estate planning does not start with the selection of heirs or beneficiaries in all cases, but it can start in this way where wills and trusts are concerned. When it does, it may be more effective than if some less critical ingredient is given priority. As noted earlier, merely avoiding probate is not a valid motivation for establishing a trust.

Both the *who* and the *what* of trust beneficiary designation deserve thorough attention. The people who will or must qualify in your thinking as beneficiaries include, primarily, those who stand in some close relationship to you. Who are these persons? Most immediately, your spouse, lover, children, and so on. But others may also qualify, among them: parents, children-in-law, grandchildren, brothers and sisters, collateral relatives, friends, servants, business associates and employees, and the recipients of specific charitable contributions or distributions.

Such a list posits some basic verities. The process of planning the estate, and in particular the estate including a trust, begins with the estate owner himself. It proceeds to those persons who are dependent on the owner, his estate, or both. The process continues by including those legally dependent on the estate for support and preparation for a productive life. Those farther down on the list include all who may be eligible for benefits for moral or sentimental reasons.

The what of providing for beneficiaries focuses attention on the life situations of the several beneficiaries. The trustor now faces the task of asking himself, with reference to each person with whom he has important ties, what problems or potentials are involved. The questions that may arise could include:

- What is, and will be, this beneficiary's financial position?
- On a long- or short-term basis, what will he or she need?
- Does the person need capital, or will he or she and when?
- Can the person manage money?
- Should the potential beneficiary be protected against the burdens and responsibilities of administrative and investment chores and decisions?
- Will he or she need specific kinds of assets or training to be prepared for life, and what assets would be required?
- Will such special arrangements as separate trust funds, guardians, or waivers be needed to provide for or against particular rights, liabilities, or disabilities?

To answer these questions, you need to have details, for example, on the beneficiaries' ages, health and financial circumstances, particular competencies, and established standards of living. In most cases, your familiarity with their situations will enable you to fill in the necessary details.

Authorities generally agree that estate planning requires early consideration of people. As trusts become integral to an estate plan, they certainly impose a similar requirement. The estate has little meaning except in relation to the people who will eventually use it and benefit from it. Even where a trust is created partly or primarily to avoid payment of unnecessary taxes, the corpus so protected must benefit someone.

In some cases, enduring obligations or needs virtually dictate

what provisions must logically be made. For instance, as long as he or she lives, an invalid will probably remain dependent on support and assistance of a certain kind. The costs of such support and aid can usually be estimated in advance. A young person will need a fairly predictable amount of money to continue his or her education over a stated period of time. An elderly person living in a retirement home will need a specified amount of support to remain comfortable or maintain residence.

KINDS OF NEEDS

Human needs obviously fall in different categories. They can be satisfied only if you give some thought to them—and sometimes they can be only partially satisfied. The exceptional case might be that of the very rich person who has almost unlimited assets: This person can indulge every whim in the disposition of his estate and still, probably, have plenty of money left over for a favorite charity.

Most of us, fortunately or unfortunately, fall in some middle range of affluence. We have to wonder whether our estates will actually cover our basic commitments, or support our families in the style to which they have become accustomed while we could actively contribute income.

Trusts, as noted, come frequently under scrutiny when estate planning has reached the need-assessment stage. Different kinds of needs that will continue over specifiable or unspecifiable periods of time, in varying degrees of intensity, can be met by including the appropriate trust terms. Multiple trusts can be created to take care of the needs of different beneficiaries. Trustees can have discretionary powers that account for varying degrees and types of needs.

The people with whom you have close or meaningful relationships can, in other words, be accounted for through creation of the proper trust.

DETERMINING NEEDS

Determining the human needs that you believe should be given attention may require some time and thought. You may not even be able to estimate exactly what your surviving family members will need—in part because those needs will vary with age and according to health and other factors. Inflation introduces an element of unpredictability.

At least one rule of thumb helps in assessing family needs. The typical pension plan offered in business and industry establishes retirement benefits that are gauged to account for about 40–60 percent of the average peak income of the breadwinner. If that measure is valid for your beneficiaries, it may be extrapolated to their situations. Family members or others you have supported may, in other words, require 40–60 percent of the income with which you provided them while employed if they are to maintain their standards of living.

In considering trusts with an eye to providing for people who are dependent on you as provider, and will be dependent on your estate, the standard of living clearly serves as a determinant of need. But what does *standard of living* mean? It obviously cannot be specified in precise dollars-and-cents terms. The 40–60 percent yardstick may offer the only mathematical approach to need assessment.

Yet the testator or trustor can ask questions. The answers may well go farther to indicate needs than any other method. Some of the questions that may be asked include:

- Does your wife have children by a former marriage, and do these children receive child support payments from a former husband?
- Do any children in your family—yours or your spouse's—have vested or contingent expectancies? These may come from other trusts or life insurance policies; or a child may, for one reason or another, expect to receive an inheritance from someone inside or outside the immediate family circle.
- Do you or your favorite other person have community property or joint interests that could complicate the planning process?
- Are stepchildren to be provided for or omitted from consideration?
- How old are the various children for whom you are concerned?
- What are their tendencies, attitudes, characters, and habits?
- How long have you and the significant other person in your life been associated?
- What career ambitions and prospects do your various family members entertain?

- Have you a relative, such as an aged parent, for whose support you feel a moral obligation?

YOUR NEEDS AND GOALS

Assess as you will, your own needs and goals will probably affect your decisions on estate disposition more than any other factor. Those needs and goals will affect your choice of dispositive instruments—whether will or trust. The needs and goals will inevitably spring from your own situation and feelings.

In one case, a husband-provider has children by a previous marriage while his present wife has no children of her own.

In another case, both a professional working wife and her new husband have children from previous marriages.

In a third case, a husband has no children, but his wife has children by a previous marriage.

In a fourth situation, a working wife has children by a previous marriage, but her spouse does not, and more children have been produced by the present marriage.

The permutations on these themes could be enumerated endlessly. In each situation, the needs and goals could be different. Whatever the situation, the trust can answer all your needs if carefully prepared.

As *paterfamilias*, you may have decided to include all your children as beneficiaries under one trust. The beneficiaries include stepchildren as well as natural children. But the needs in some instances are greater than in others. As the chapters on the various kinds of trusts indicate, a trust arrangement exists for every need.

As *materfamilias*, widowed young and with a brood of five children to support, you may feel unqualified to administer and invest the half-million-dollar estate you inherited. Insurance payoffs may represent the bulk of that estate. But you hope to remarry, and you want to provide for the children of your earlier marriage first. You establish a trust that will take care of you initially and your children eventually.

The lesson here can only be stated in general terms. Your goals have to spring from your sense of your own responsibilities. Your views of your own needs and goals have then to be integrated with

your assessment of the needs and ambitions of those persons for whom you wish to provide. Out of the integrative process come the terms that you embody in the will or trust.

Some basic principles may need restating. For example, estate planning is not a game to be played for the fun of it. In essence, in planning your estate disposition you are providing against (1) untimely death from whatever cause; (2) unnecessary dissipation of your estate, whatever its size, through taxation or by other means; and (3) loss of dignity or independence by you or yours as time passes and your situation changes.

A trust may be your ideal answer.

Appendix

SAMPLE LIVING TRUST AGREEMENT

This Trust Agreement, identified as Trust Number _____, executed in duplicate at Juniperville, Delaware, this _____ day of _____ 19____, between _____
(hereinafter called the "Trustor"), and

ANYWHERE TRUST & SAVINGS BANK

a Delaware corporation of Juniperville (hereinafter called the "Trustee"),
Witnesseth:

That the Trustor, in consideration of acceptance hereof by the Trustee, as evidenced by the Trustee's signature hereto, and of other good and valuable considerations, does hereby assign, transfer, convey and deliver to the Trustee, the property described in the schedule written hereon or attached hereto and hereby made a part hereof, entitled "Schedule B,"

To have, receive, hold, administer and dispose of said property, and any additions thereto, as a Trust Estate, upon and subject to the trusts, terms, powers, agreements and conditions hereinafter set forth.

Schedule of
Beneficial
Interests

FIRST: The Trustee shall pay and dispose of the income and principal of the Trust Estate as provided by the schedule written hereon or attached hereto and hereby made a part hereof, entitled "Schedule A." Income accrued but not due at the time of Trustor's transfer of property to the Trustee, shall be treated and disposed of as income, unless otherwise provided by said schedule.

Additional
Property May
Be Added

SECOND: The Trustor shall have the privilege to convey, assign, transfer and deliver additional property to the Trustee hereunder, and the Trustee shall receive and administer such additional property in the same manner as herein provided in respect to the property forming the original Trust Estate.

Agreement
May Be
Altered or
Revoked

Property
May Be
Withdrawn

Trustee Shall
Render State-
ments

Beneficiary's
Interests Are
Not Assignable
or Subject to
Debts

Notice to
Trustee of
Events Affect-
ing Interest
of Beneficiary

THIRD: The Trustor reserves the power, exercisable repeatedly from time to time as often as desired, to modify, amend, or revoke this agreement, in whole or in part, or to withdraw all or any part of the Trust Estate, by an instrument in writing signed by the Trustor and received by the Trustee during the Trustor's lifetime; provided, however, that the duties, powers, and liability of the Trustee hereunder shall not be substantially altered without its written consent; and provided, further, that the Trustee shall be fully indemnified against any and all liability incurred, arising or which may or might arise at any time thereafter in any manner out of any act or acts of the Trustee performed in good faith in the execution of this trust.

FOURTH: The Trustee, upon written request, shall render statements of account at reasonable intervals showing the condition of the Trust Estate and its receipts and disbursements for the period to the beneficiary or beneficiaries receiving the income at the time.

FIFTH: No beneficiary hereunder shall have any power to sell, assign, transfer, encumber or in any other manner to anticipate or dispose of his or her interest in the trust estate prior to the actual distribution thereof by the Trustee to or for said beneficiary. Neither the principal nor income of the trust estate shall be liable for the debts or other obligations of any beneficiary.

SIXTH: It shall be the duty of all persons interested in disposition of principal or income to notify the Trustee of the existence or happening of any event which terminates, negatives or modifies the right of any person to receive income or principal payments or distributions, or which entitles any person to receive any such payments or distributions, and the Trustee, notwithstanding the existence or happening of such event, shall receive full credit in its accounting, for any payment or distribution made by the Trustee in good faith and without notice, which would have been a proper payment or distribution if the event had not existed or happened. Although the Trustee shall

be fully acquitted with respect to any such payment or distribution, nothing herein shall prejudice any right of action of the Trustee or of any beneficiary to recover from any person receiving an improper payment or distribution, the amount or value of the payment or distribution, improperly made.

Violations
of Rule
Against
Perpetuities
Avoided

SEVENTH: Anything in this Agreement to the contrary notwithstanding, the Trust Estate existing at the expiration of the period of twenty-one years after the death of the last survivor of Trustor and all beneficiaries hereunder who are in being at the date hereof, if not then or previously vested by the terms of Schedule A, shall vest at the expiration of said period, in the person or persons then entitled to the income therefrom, and in the proportions in which so entitled to income, and distribution shall be then made in accordance with such vesting, excepting and to the extent, if at all, that possession and management of any distributive interest so vesting shall be temporarily deferred pursuant to the next succeeding paragraph hereof or by provisions in Schedule A not violative of the rule against perpetuities.

Retention of
Beneficiary's
Share until
Age Twenty-
One

EIGHTH: Unless otherwise provided in Schedule A, if any beneficiary becoming vested with a distributive interest in the Trust Estate under the next preceding paragraph hereof, or under the terms of said Schedule, shall be of an age less than twenty-one years, then in each such instance, although such beneficiary's interest shall vest at the time provided by said preceding paragraph or by said Schedule, possession and management of his or her distributive share may be deferred by the Trustee, in its discretion, and the Trustee may retain said beneficiary's distributive share, as a separate trust estate, and pay to him or her the net income therefrom and such, if any, sums from the principal thereof as the Trustee may deem necessary from time to time for his or her support and education until he or she shall reach the age of twenty-one years at which time the separate Trust Estate shall be paid and transferred to the beneficiary, and if said beneficiary shall die before reaching that age, the separate Trust Estate

shall, upon such death, as an interest previously vested in the beneficiary, be paid and transferred to the person or persons entitled thereto, tracing his or their right through the deceased beneficiary.

Succession
to
Accrued
Income

NINTH: Any income accrued or undistributed at the termination of any estate or interest shall be paid by the Trustee as income to the persons entitled to the next successive interest in the proportions in which they take such interest.

Powers of
the Trustee:
to Retain
Property

TENTH: In executing the trusts herein created the Trustee shall have full power and authority to receive and retain as a part of the Trust Estate any and all property, both real and personal, which may be conveyed, assigned, transferred or delivered to it hereunder, without liability for any decrease in value thereof, and including any unproductive property which for reason of sentiment or otherwise it may deem advisable to retain; to invest and reinvest the Trust Estate in securities and property of its selection, including participations in common trust funds, having regard for the safety of the principal of the Trust Estate but without being subject to any restrictions now or hereafter imposed by any law relating to the investment of trust funds; to purchase any property comprising a part of the estate of the Trustor from, and to make secured or unsecured loans to, the Executor of the will or Administrator of the estate of the Trustor, or any testamentary trustee thereof, and to retain any such property as part of this trust, without liability for any loss resulting by reason of any such purchases or loans; to sell at public auction, at broker's board or at private sale, with or without notice, for cash or upon credit; to exchange, subdivide, improve, vacate, dedicate to public use, adjust boundaries and/or partition property, to pave streets and alleys, and to adjust differences in value by giving or receiving money; to lease, with or without option to purchase, for any term or terms with such covenants as to erection of buildings, for renewals or otherwise as shall seem to it best, even though the term of the lease or renewals thereof extend beyond the term of any trust hereunder; to vote at corporate meetings by proxy or to refrain from voting, and to

Invest

Deal with
Trustor's
Estate

Sell

Deal with
Real Estate

Vote Stocks

Protect
Investments

Apportion
Receipts and
Disbursements

Pay Expenses

Hold Securities in Various Manners

Delegate
Duties

Borrow Money
and Pay
Encumbrances

Erect and
Repair
Buildings

Compromise

Distribute
in Kind

consent to the reorganization, consolidation, or merger of any corporation or to the sale or lease of any of the corporate property; to pay all assessments, subscriptions and other sums as the Trustee may deem expedient for the protection of any property of the Trust Estate; to determine what is income and what is principal hereunder and to provide for the depreciation or depletion of any property of the Trust Estate in such manner as it shall deem fair and equitable to all beneficiaries hereunder; to pay expenses of the trust, including all taxes levied against the principal or income of the Trust Estate or otherwise, and to receive and retain reasonable compensation for its services hereunder; to determine the mode in which such expenses shall be borne as between principal and income, and as between the various trusts or shares herein provided; to cause any securities held hereunder to be registered in its name as Trustee hereunder, or its own name, or the name of its nominee, or to take and keep them unregistered, or in such condition that they will pass by delivery; to delegate to other persons or corporations such powers and duties as it may deem for the best interests of the Trust Estate; to advance or borrow money and to hold, mortgage and/or pledge property for repayment thereof; to pay or renew, in whole or in part, any mortgage or other encumbrance upon all or any part of the Trust Estate; to raze existing buildings and/or erect new buildings with or without joining with other owners of adjacent property; to make such ordinary and extraordinary repairs or alterations in buildings as may seem to it best and to apportion the expense thereof between principal and income as it shall deem equitable; to grant discounts, and to settle and compromise any claim or cause of action; to enter into contracts of any kind with respect to or affecting any trust property; to make distribution, divisions or allotments of property to trust funds or in payment of gifts in kind at valuations determined by it; to allot to any separate trust or share created hereunder an undivided interest in any property of the Trust Estate, and to make joint investments for such trusts or shares; to employ counsel and to rely upon the advice

Other
Powers

thereof; to execute and deliver such deeds, assignments and other instruments as it may deem appropriate in connection with the exercise of any power; and to do and perform any and all such further and other acts and things as it shall deem necessary or advisable in effectuating the purposes hereof, with full power to deal with and with respect to the trust property in all ways as fully as any person may deal with or with respect to his own property, the specification herein of particular powers not to be construed as limiting the general power hereby given. This trust, and all rights, powers and authority conferred upon the Trustee hereunder shall continue until the distribution of the Trust Estate as herein provided shall have been fully completed. Any act or decision of the Trustee performed or made in good faith hereunder shall be binding and conclusive upon all parties in interest.

Consolidation
with Similar
Trusts

ELEVENTH: Insofar as may be practicable, the Trustee may consolidate any separate share of the Trust Estate with any other trust or trusts created by the Trustor or any member of his family by Will or Agreement, and may hold, administer, and invest the several trusts as one or more common fund or funds, and make joint or several distributions of income and principal thereof, whichever the Trustee deems advisable.

Discretion
as to Method
of Paying
Minors, etc.

TWELFTH: If, at any time or times, income is payable hereunder to or for the benefit of, or principal for the purpose of support, maintenance or education is payable hereunder to or for the benefit of, any person who is a minor or under other legal disability, or any person not under legal disability but who, by reason of illness or mental or physical impairment, is in the Trustee's judgment unable properly to administer such payments, the Trustee may make payment thereof, in whole or in part, in such one or more of the following ways as the Trustee shall consider for the beneficiary's best interest: (1) to the beneficiary in person, regardless of disability, if the Trustee shall consider him or her to be of sufficient judgment to receive and properly apply the payment, or (2) to the legal guardian or con-

servator of the estate of the beneficiary, or (3) by direct expenditure by the Trustee for the beneficiary's benefit, or (4) to any relative by blood or marriage, or friend or other person deemed trustworthy by the Trustee, to be applied by such person for the benefit of the beneficiary, the Trustee in such case to be fully acquitted by the receipt of such person, regardless of the application made by him or her of the payments so made.

Resignation
of Trustee

THIRTEENTH: The Trustee may resign the trusts hereby created during the lifetime of the Trustor by an instrument in writing delivered personally or by registered mail to the Trustor, and after the death of the Trustor by an instrument in writing so delivered to the adult beneficiaries not under legal disability then receiving the income from the Trust Estate. In the event of such resignation or of the Trustee's inability to act, the Trustor if living, or a majority of the adult beneficiaries not under legal disability then receiving income from the Trust Estate if the Trustor be not living, may appoint a successor by an instrument in writing lodged with the Trustee, having endorsed thereon the acceptance of such successor; and the Trustee resigning shall convey, assign and deliver to the successor so appointed all property then held hereunder, and the receipt of the successor trustee so designated shall be a full and complete acquittance and discharge to the resigning Trustee.

Appointment
of
Successor

Transfer
of Situs

FOURTEENTH: The situs of the Trust Estate may be transferred to such other place as the Trustee may deem to be for the best interests of the Trust Estate. In so doing, the Trustee may resign and appoint a successor Trustee, but may remove such successor Trustee so appointed and appoint another, including itself, at will. Each successor Trustee so appointed may delegate any and all trustee powers, discretionary and ministerial, to the appointing Trustee as its agent.

Merger

FIFTEENTH: If the Trustee or any successor trustee shall at any time or times hereafter become merged or consolidated with any other corporation or corporations, or shall reorganize or reincorporate, the corporation so formed, or succeed-

ing to the business of the Trustee, shall become the trustee hereunder. Every successor trustee shall be vested with all the estates, rights, powers, titles, discretions, privileges and immunities of the original Trustee as though such successor had been an original party to this instrument.

IN WITNESS WHEREOF, the Trustor has hereunto set his/her hand and seal and the Trustee has caused these presents to be executed on its behalf by its duly authorized officers and its corporate seal to be hereunto affixed as of the day and year first above written.

ANYWHERE TRUST & SAVINGS
BANK
By _____
Vice-President and Trust Officer

Attest: _____
Assistant Secretary

GLOSSARY

- accumulation distribution** The distribution in a current year of funds from a trust consisting of income earned and accumulated in prior years.
- administration** The process of collecting a decedent's assets, paying his or her debts, and distributing any remaining assets. Also the management of property placed in trust.
- administrator, administratrix** The person named by the court to assume the responsibility for administration of the assets of a decedent who leaves no will.
- alternate trustee** A person named or selected to serve as trustee in case the primary trustee cannot or will not discharge the trustee's duties.
- antilapse statute** Legislation that specifies conditions under which a gift by will remains valid if the donee dies before the testator.
- appointment** The act by which a beneficiary under a trust names another person as beneficiary. Many trust instruments confer powers of appointments in specific terms.
- appraise** To use systematic procedures to establish cost or value of goods or real estate. The procedures may include physical examination, pricing, and/or engineering estimates.
- appraiser** One who conducts formal appraisals.
- ascendants** Those persons to whom one is related in a direct ascending line. Examples are one's parents, grandparents, and great-grandparents. See *descendants*.
- beneficial interest** An equity interest in property held in trust. The beneficial interest is distinguished from the legal interest. See *equity*, *legal interest*, *ownership interest*.
- beneficiary** A person receiving, or named to receive, benefit or advantage; under trust law, one for whose benefit a trust is created. A beneficiary is legally entitled to receive property whose title may be vested in another, such as a trustee. See *heir*.
- bequest** A gift, by will, of personal property. See *conditional bequest*, *devise*.

business trust A kind of business organization that has many of the characteristics of a trust and is formed for the purpose of carrying on a business venture.

charge and discharge statement A summary in tabular form, for an administrator, executor, trustee, or other fiduciary, that accounts for the principal and interest for which the fiduciary has been responsible; an interim or final report of activities.

charitable remainder A property interest that is transferred to a specific charity, holding a remainder interest, on expiration of a life estate or other tenancy or interest. See *life estate*, *remainder interest*.

Clifford trust See *reversionary trust*.

codicil A written change in or an addition to a will.

common law The body of statutes, juristic theory, and decisions that originated in England and was brought to America by English colonists. The basis of common law is essentially court decisions unrelated to legislative enactments.

community property Goods or other property held in common by a husband and wife.

complex trust In income tax terms, any trust that is not a simple trust. See *simple trust*.

conditional bequest A gift to which a donee gains title on the occurrence of a specific event. See *bequest*.

corpus, or trust corpus The property that has been set aside in trust or from which income is expected to accrue; the trust principal.

creator See *trustor*.

deduction for distributions The deduction allowed on a fiduciary income tax return for income currently paid, credited, or otherwise required to be distributed to beneficiaries.

descendants Those persons to whom one is related in a direct descending line, such as children and grandchildren. See *ascendants*.

descent Disposition of the real property of a person who dies intestate. Laws governing intestacy are often called laws of descent and distribution.

devise To dispose of real estate by will to a devisee or devisees. See *bequest*, *devisee*.

devisee One who receives real estate under the terms of a will. See *bequest*, *devise*.

discretionary power The power given a fiduciary under a trust to exercise judgment in the performance of a variety of fiduciary functions and responsibilities.

dispositive provisions Those provisions of a trust instrument that provide for distribution of specific trust property under specified conditions to named individuals.

distributable net income The taxable income of a trust for a year, computed for fiduciary income tax purposes with certain modifications.

distribution The apportionment or payment of trust property, whether

income or principal; the apportionment and disposition, by court authority, of an intestate's personal property after payment of debts and costs.

distribution per capita In the laws of inheritance, a form of distribution under which heirs in equal degrees of relationship to a decedent, and claiming a direct interest in the decedent's estate rather than an indirect interest through another or others, receive equal shares. See *distribution per stirpes*.

distribution per stirpes In the laws of inheritance, a form of distribution under which heirs such as collateral relatives of a decedent claim through others or another and receive only what the other would have received if that person had been alive when the testator died. See *distribution per capita*.

donor A person who makes a gift; a trustor.

equity Technically, a system of jurisprudence, developed in England, that functions parallel to, and in some ways independently of, common law.

estate A person's property considered as an entity. An estate is often a decedent's property in process of administration.

estate accounting The process of preparing and keeping accounts on property administered or managed by executors, administrators, and trustees.

estate tax The federal tax levied against the estate of a decedent if the estate exceeds a certain size in terms of overall value. See *inheritance tax*.

executor, executrix The person or corporation named in a will to carry out its provisions regarding distribution of property and to pay the decedent's debts.

express trust A trust that has been created by specific provision in a deed or other written instrument. See *implied trust*.

fiduciary An individual or firm responsible for the administration or custody, or both, of property belonging to another; a trustee, executor, or administrator.

fiduciary accounting The entire process of preparing and keeping accounts for property in the hands of a trustee, executor, administrator, or other fiduciary.

grantor trust A trust that fails to meet certain income tax rules. The property in the grantor trust is viewed as being owned by the grantor for income tax purposes.

guardian One who, by court order, is responsible for the care of the person or property of another.

heir One who receives property or the benefit of property under the terms of a will. An heir is distinguished from a beneficiary, one who benefits under a trust.

implied trust A trust whose existence is implied in the details of a transaction between or among two or more persons. See *express trust*.

- income beneficiary** The person entitled to receive the income from property held in trust. See *principal beneficiary*.
- inheritance tax** The tax levied by a state against those persons who have inherited property from a decedent. See *estate tax*.
- interest** The expectation on the part of a trust beneficiary that he will or may receive a distribution of trust income or principal.
- inter vivos trust** A trust created during the lifetime of the trustor; also called a living trust. See *testamentary trust*.
- intestate** Having failed to make out a will. See *testate*.
- irrevocable trust** A trust that cannot, at least in theory, be changed or terminated by the trustor. See *revocable trust*.
- legal interest** An interest, directly protected by law, in property held in trust. A legal interest may also be called an ownership interest. See *beneficial interest, ownership interest*.
- life estate** A kind of property interest whose duration is limited to the life of the person holding it or of some other person. See *charitable remainder, remainder interest*.
- living trust** See *inter vivos trust*.
- marital deduction** An entitlement, written into the Internal Revenue Code, under which one-half of the gross estate of a deceased spouse may be left to the surviving spouse free of estate taxes.
- marital deduction trust** A testamentary trust that meets specific tax requirements so that the trust property can qualify for the marital deduction.
- ownership interest** The interest held by a person, firm, or corporation owning or controlling property, including guardians or trustees. See *beneficial interest, legal interest*.
- personal property** As distinguished from real property, all property of a temporary or movable character.
- pour-over trust** A trust, existing independently of a will, that serves as a receptacle for property given it by the will at the time of the testator's death.
- power of appointment** See *appointment*.
- principal, or trust principal** See *corpus*.
- principal beneficiary** The person entitled to receive the principal or corpus, as distinguished from the income, of a trust. See *income beneficiary*.
- prudent-man rule** As applied to the investment of trust funds by a trustee, a rule of thumb that limits the trustee to making only such investments as a prudent man would make of his own property.
- real property** Land and all the improvements on it, including "buildings and appurtenances." See *personal property*.
- remainder interest** A property interest that is transferred to a specified person or entity after another tenancy or life estate expires. See *charitable remainder, life estate*.
- remainderman** A person or entity holding a remainder interest.

res, or trust res See *corpus*.

reversion The return of property to a former titleholder, as, for example, on termination of a ten-year or reversionary trust.

reversionary trust A trust established irrevocably for a period of at least ten years; a Clifford, or short-term, or ten-year trust.

revocable trust A trust that can be terminated or changed by the trustor, either at will or under specified conditions. See *irrevocable trust*.

right of survivorship The right or ability to become entitled to property by outliving another person who held an interest in the property.

settlor See *trustor*.

short-term trust See *reversionary trust*.

simple trust For income tax purposes, any trust whose income, under the terms of the trust instrument or by law, must be distributed currently to beneficiaries other than charities. See *complex trust*.

sprinkling trust A trust whose terms provide that the trust income can be distributed among specified beneficiaries as the trustee thinks best.

successor trustee A person named to assume the duties of a trustee where an earlier fiduciary dies or is disqualified for any reason.

tentative trust A trust created by a trustor who places funds in a bank account to be held in his or her own name as trustee for another. The tentative or Totten trust is regarded as a provisional trust that can be revoked at will until the depositor dies.

ten-year trust See *reversionary trust*.

testamentary trust A trust, created by will, that comes into being on the death of the trustor. See *inter vivos trust*.

testate Having made out a will. A decedent is said to have died testate or intestate.

testator One who makes out a will.

Totten trust See *tentative trust*.

trust A fiduciary agreement, established by a grantor or trustor, under which one person or entity, the trustee, holds legal title to property subject to an equitable obligation to use the property for the benefit of another.

trust fund A fund made up of property to which one person or entity, the trustee, holds legal title subject to the equitable right of another or others to derive benefit from the property. See *trust corpus*.

trust instrument A written document that sets forth the terms and conditions under which trust property or a trust fund is to be administered.

trustor A person who creates a trust; also called a creator, donor, grantor, or settlor.

will An instrument by whose terms a person makes a disposition of his property to take place after his death. A will remains revocable, or subject to change, during the testator's lifetime.

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